

EU CORPORATE TAX REFORM

REPORT OF A CEPS TASK FORCE

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This report contains the conclusions and policy recommendations that follow from the discussion and analytical presentations that took place at the meetings of the CEPS Task Force on EU Corporate Tax Reform. The members of the Task Force participated in extensive debate and submitted comments on earlier drafts of the report. Its contents contain the general tone and direction of the discussion, but its recommendations do not necessarily reflect a full common position reached among all members of the Task Force, nor do they necessarily represent the views of the institutions to which the members belong. A list of participants and invited guests and speakers appears at the end of the report.

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CONTENTS

Executive Summary.....	i
The policy choices.....	i
Options for a future EU tax system.....	ii
Introduction by <i>Malcolm Gammie</i>	1
Ideal options for corporate taxation in Europe	1
A common corporate tax base for Europe.....	1
Problems in achieving a common corporate tax base	2
Options for progress on corporate taxation in Europe	4
HST and Optional CBT as paths to a solution.....	7
Part I. The New Politics of Corporate Taxation in the European Union	
<i>Claudio M. Radaelli</i>	9
1. Introduction	9
2. The OECD arena: More voices in the policy process, more politicisation, more cooperation with business.....	10
3. The current EU strategy: Progress, ambiguity and connected games	18
4. New political dynamics in EU tax policy.....	22
The voting issue: Is QMV the real issue?	22
The code of conduct: open coordination method in disguise?	24
Enhanced co-operation: a new window of opportunity for tax policy development?	24
Less harmonisation, but more action on infringements?	25
From a single-issue tax policy to a multi-dimensional strategy: an opportunity for the business community?	25
5. Conclusions: Balancing negative and positive integration.....	26
Part II. Economic Review of Formulary Methods in EU Corporate Tax Reform	
<i>Alexander Klemm</i>	30
1. The current situation in the EU.....	30
1.1 Problems of SA in integrated economies.....	31
1.2 Other issues that arise in case of tax reform	33
2. Recent reform proposals	35
2.1 European corporate income tax (EUCIT).....	35
2.2 Common base taxation (CBT).....	36
2.3 Home state taxation (HST)	36
2.4 Abolition of corporate income taxation	37
3. The definition of the tax base	37
3.1 Common feature of EUCIT, CBT and HST	37
3.2 Differences between the proposals.....	41
3.3 The territorial scope of formula apportionment.....	46
4. The choice of formula	48
5. Other proposals	53
6. Conclusion.....	54
References.....	55
Appendix: Comment from <i>Niclas Virin</i> , Member of the Task Force.....	58
Members of the Working Party and Invited Speakers and Guests.....	60

EXECUTIVE SUMMARY

A coherent EU policy is needed for corporate tax reform, going beyond the 1997 tax package. A clear direction should be set by European policy-makers towards EU-wide taxation of groups of companies and a common tax base. This will require agreement on a formula to apportion taxable income across the EU's member states.

The bundling of three different tax issues at the EU level — the code of conduct, savings taxation and fiscal state aid — has brought major breakthroughs in the direct taxation debate. The limitations and ambiguities of this strategy, however, are becoming apparent and a new direction is needed. Questions remain regarding the reach of the Primarolo Report and the 66 harmful tax measures in the EU, which the EU Council has not yet discussed and endorsed. The Commission is exploiting its powers in the area of state aids to put pressure on member states. And the European Court of Justice has targeted distorting domestic tax laws. As a result, reforms undertaken at the national level in response to these actions tend to be uncoordinated and to lack direction.

The policy choices

The question then becomes what direction is most appropriate for EU corporate tax policy? In this report we suggest that a fundamental goal of EU corporate tax policy should be to balance positive integration (that is, market-shaping tax policies) and negative integration (that is, market-creating tax policies). To understand why this balance is important, one should observe that there are two types of distortions in the single market: for simplicity, we call them tax holes and tax obstacles.

The fight against harmful tax competition aims to tackle the issue of tax holes by using positive integration. The idea behind the current tax package is based on positive or market-shaping policies, that is, policies aimed at governing or directing the market. The official rhetoric in the EU fight against harmful tax competition stresses the need to curb *unbridled* harmful tax competition – a clear indication of the intention to steer a process. Market-shaping policies (or positive integration), however, make sense only if a single market exists for tax purposes. Conceptually, positive integration is a step that should *follow* negative integration. One should first strike down the obstacles to the single market; then one should try to shape or govern the undesirable aspects of the market.

The negative integration component of tax policy, however, is still embryonic at best. The 1990 directives (on parent-subsidiaries and mergers and acquisitions), the action of the European Court of Justice, and the proposal for a directive on interest and royalty payments do not represent an adequate framework for an effective action against tax obstacles. To achieve a balance in EU tax policy, dealing with tax obstacles should become at least as important as dealing with tax holes.

This means addressing the following problems companies face in doing business in the Community:

- the maze of different rules for the calculation of profits;

- the need to justify prices between related and increasingly integrated enterprises as arm's-length prices when no comparables may be available;
- the presence of fifteen different tax authorities, which implies different administrative styles and requirements, and different approaches to cross-border tax disputes; and
- the differences in the tax base.

It should be possible to achieve a proper balance between positive and negative integration now that the relationships between institutions and the business community are changing. Both the OECD and the EU are more actively engaged in dialogue with business than in the past. Several joint initiatives, policy fora and studies are underway. The two panels established by the Commission on effective tax rates and the tax obstacles to the single market are the most important acknowledgement that a more balanced approach is needed. The recent policy on tax infringements – inaugurated with the Communication on the elimination of tax obstacles to the cross-border provision of occupational pensions – aims to create the tax conditions conducive to the single market, thus pursuing a negative integration approach.

In terms of policy instruments, the Commission is seeking to enrich the menu of instruments used to advance tax policy. In the future, the Commission is unlikely to propose the use of directives in addressing direct tax issues and may seek to use more flexible instruments. The use of an open coordination method need not be restricted to the code of conduct. Indeed, it could be one of the options to consider in the reform of EU corporate taxation. The Commission may also use enhanced cooperation when a critical mass of countries (but not all of them) wish to take a common position on taxation. It is unlikely that enhanced cooperation will be used in areas such as the taxation of savings, but there is scope for enhanced cooperation in policies aimed at attacking the tax obstacles to the creation of the single market.

The political climate and the new directions in terms of policy instruments create an opportunity for a coherent corporate tax policy for the single market. The questions are what is the final objective, what needs to be done, and how can the EU do it?

Options for a future EU tax system

One thing is clear: unless member states dispense with taxing corporate profits, there can be no final solution to the tax issues of companies doing business in the single market without the adoption of EU-wide group taxation and a common tax base. This is the only satisfactory long-term solution and should be the direction of EU corporate tax policy. It requires a definition of the EU group, a single computation of EU profit for the group and a uniform formula to apportion that profit among the member states. As this report indicates, monetary union, the creation of the single market and greater cross-border activity of EU companies increase the urgency for member states to make progress towards a common European corporate tax base.

But while that much is agreed, the question is how can member states move from fifteen different corporate tax systems to a common corporate tax base in every member state? The CEPS Task Force has considered two particular ideas for progress to that objective – Home State Taxation (HST) and optional Common Base Taxation (optional CBT):

- HST allows European enterprises (companies, branches and groups) to be taxed solely by reference to the tax rules of their elected ‘home state’. Each member state in which the enterprise operates shares in the profits calculated under home state rules and allocated under an agreed formula.
- With optional CBT, member states agree common rules for computing corporate profits (i.e. a common tax base) but allow companies the option either to use the domestic tax base of each member state in which they operate or to adopt the common EU tax base for the totality of their EU operations.

Both proposals allow companies to compute their EU profits under a single set of rules (rather than under 15 different rules) and to apportion those profits across the EU to be taxed in the individual member states. Thus, both HST and optional CBT require agreement by member states on some uniform formula to apportion profits.

Three main issues must be resolved in any formulary system before the EU could consider replacing the current arm’s length system with HST or optional CBT. These issues are:

- 1) the definition of an EU-wide group;
- 2) the composition of the formula and the definition of the factors used in the formula to apportion income; and
- 3) the creation of greater cross-border administrative cooperation and capabilities.

The report examines the experience in countries that have formula systems in place to gain insight into the issues that arise in defining an EU-wide group and devising a satisfactory apportionment formula.

If these issues are common both to the final solution of a common EU corporate tax base and to the proposed paths to that solution – HST and optional CBT – how do HST and optional CBT differ and which is to be preferred?

At a technical level, optional CBT appears the better proposal. While it leaves in place fifteen different domestic tax systems that companies may choose if that suits them better, optional CBT produces a single tax base that companies operating throughout the EU may prefer to use for the advantages that it offers in terms of simplicity, compliance costs and administration.

Nevertheless, it does require member states to define a common EU-level tax base at the outset. In doing so, it appears to face the same problems that previous attempts to define a common base have faced: namely, that member states are unable to agree on how the common tax base should be defined. Thus, at first glance, optional CBT does not appear to improve on previous efforts at EU company tax reform.

Proponents of optional CBT, however, point out that a CBT *parallel to* (rather than replacing) present domestic systems may assist governments to agree and implement a common tax base for companies operating in different member states. The most important aspect of this parallel approach is that governments are not required to change their domestic tax legislation (other than to allow companies with branches and subsidiaries in different member states the option of adopting the common tax base). Moreover, governments will preserve tax sovereignty over their domestic tax bases and

tax rates and purely domestic companies will continue to be taxed under the domestic system.

Accordingly, member states should be more inclined to agree a common tax base than if they were seeking to define a common tax base to replace their domestic tax systems. In doing so, they will also have the support of European business, which wishes member states to address the tax issues of the single market but which fears that a common tax base *replacing* domestic tax systems may impose higher tax burdens on business and may be uncompetitive.

By comparison, Home State Taxation does not require member states to agree on a common tax base at the outset. As there is no generally accepted view of how the tax base for companies should be defined, member states would mutually agree to respect the methods adopted by other member states for computing EU income (provided those methods fell within broadly agreed parameters of an acceptable corporate tax base).

As such, HST leaves in place fifteen different corporate tax systems but in effect allows companies by choosing their home state to select one of those tax systems as the common tax base that it will adopt throughout the EU. As such, HST does not require tax policy-makers to agree *ex ante* what is the 'optimal tax base' for the EU, when agreement may not be driven solely by economic analysis and optimal criteria. Instead, the flexible market-driven process of mutual recognition that HST involves will over time select the tax base that suits the single market best.

Neither HST nor optional CBT is an ideal or final solution. Optional CBT, by creating a common tax base but allowing the co-existence of fifteen alternative domestic bases, and HST with the choice it offers of fifteen alternative common tax bases, present a number of technical and administrative issues for European businesses and member states. Nevertheless, the aim of each proposal is to encourage convergence in the fifteen existing corporate tax systems, through facilitating agreement in the case of optional CBT and through market-driven convergence in the case of HST.

Ultimately, therefore, each proposal is justified in terms of the need to find practical ways of moving towards the ideal single market solution for taxing corporate profits, namely a single corporate tax base adopted on an EU-wide basis. In this respect, any final assessment of the potential of HST and of optional CBT as steps to that end should involve an assessment of whether HST would produce convergence or growing diversity of tax bases, and whether an Optional CBT would preserve the integrity of the initial agreement on the common base or would involve continuing competition between (and, as a result, erosion of) both the common and domestic tax bases.

Although many players in the EU are eager to solve the tax problems faced by enterprises with EU-wide operations, the underlying economic conditions as well as the political conditions may not yet exist for the immediate adoption of radical approaches such as HST or optional CBT. Nevertheless, the experience in countries that do not have internal tax and other barriers to cross-border activity very strongly suggests that the adoption of a single corporate tax base and an apportionment tax system will be the appropriate outcome in the long run if the EU is to continue to tax corporate profits.

INTRODUCTION

MALCOLM GAMMIE, CHAIRMAN OF THE CEPS TASK FORCE

Ideal options for corporate taxation in Europe

Tax policy within a single country rarely develops in a rational fashion. We should not expect, therefore, that the coordination of tax policies of fifteen countries should proceed in a rational fashion. In the corporate tax field, however, the final objective of any such coordination where the fifteen countries are seeking to create a single market is clear:

1. Either those countries should abolish the corporate income tax and move to taxing corporate cash flow,¹ or
2. they should impose at a European level a corporate income tax (EUCIT) at a uniform rate on corporate profits that are measured according to a common set of rules, where the resulting tax revenues either are treated as Community resources or are divided amongst member states on an agreed basis.²

No government of the existing member states³ has explicitly adopted the first option as its policy, although this option may in fact be the outcome of the current failure of member states to coordinate their corporate tax policies. And as regards EUCIT, the current political institutions of the Community have not developed to a stage that could support this solution.⁴ This, certainly, is the view the task force has adopted in its discussions of EUCIT.

A common corporate tax base for Europe

The principal alternative to EUCIT would be for member states to adopt a common corporate tax base. This would involve agreement on three principal elements:

- A common method of measuring corporate profits;

¹ This is the solution proposed by Niklas Virin, which is set out in the Appendix to this report. It is also what I suggested as the most efficient outcome in my final lecture in 1998 as Unilever Professor of International Business Law (see Gammie, 1998, in particular pp.166-167).

² In the UK single market comprising England, Wales, Scotland and Northern Ireland, there is one corporation tax, the revenues of which form part of central government resources but which could equally well be shared on an agreed basis between the four countries. If the UK wishes to tax corporate income, one tax is likely to produce a more efficient outcome than four country corporation taxes, even if coordinated. This is so both for businesses and for governments: businesses face less distortion than in the case of four country taxes; and in the case of governments, competition for the tax base between four countries may result in the four countries in aggregate raising less revenue than does one tax.

³ Although option 1 is the direction that has been pursued by Estonia, which is an applicant for membership of the EU.

⁴ Some European politicians, for example the Finance Ministers of Germany and Belgium, have suggested that there should be a European level tax (although not necessarily a corporate profits tax) to supplement the Community Budget and have noted that European businesses is likely to press for tax harmonisation in an increasingly integrated market (see *Financial Times*, 15 June 2001). Other ministers, for example those in the UK, note the different levels of taxation and public expenditure in Member States and the continuing diversity in tax systems and the relative importance of different taxes to Member States, based on the cultural, social and historical development of their tax systems.

- Which business entity (company/group) is to be used for the purposes of that measurement, and
- a uniform formula for splitting corporate profits between the member states.⁵

The Task Force is agreed that if:

- a) member states wish to achieve a single market, and
 - b) within that single market, they wish to tax corporate profits,
- then they should aim to adopt a common corporate tax base with these features.

This would resolve many of the tax issues of 15 different corporate tax systems that European business increasingly draws to the attention of governments. Agreement on a common tax basis would also to a significant extent eliminate competition (harmful or otherwise) between member states for the tax base, competition that may otherwise reduce the overall tax collected on corporate profits within Europe below its 'optimal' level.⁶

Problems for achieving a common corporate tax base

If that is so clearly the most efficient outcome, why is it so difficult for member states to recognise that and to agree a common tax base?

In answering this, we can compare corporate income tax with value-added tax. Agreement on VAT has been driven by the requirement of Article 93 of the EC Treaty that:

the EC Council shall...adopt provisions for the harmonisation of legislation concerning turnover taxes...to the extent that it is necessary to ensure the establishment and the functioning of the internal market.

There is no equivalent Treaty requirement for corporate income tax.⁷ Article 93 is not, however, the sole reason why member states have been able to agree and adopt a VAT. The truth of this is apparent when you consider that (without the imperative of Article 93) every major economy (other than the United States) has adopted a VAT that exhibits similar features to the European model.

The essential reason why it has been possible for member states to implement Article 93 and to agree directives stated in relatively general terms, is because the tax base for VAT is objectively verifiable, comprising principally easily observed and verified cash transactions. The difficulties of the VAT base are found in areas that do not involve

⁵ If member states could agree on a common tax rate to apply to corporate profits, it would be possible to agree a formula to split the tax rather than a formula to split profits, where the profits after apportionment are taxed at each member state's tax rate.

⁶ I.e. below the level that would be collected under EUCIT, although those who regard the optimal outcome as being the abolition of taxes on corporate profits would not regard the collection of any such tax as 'optimal'.

⁷ With the exception of Article 94, which reads 'The Council shall...issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market.' This has been the basis of the two existing corporate tax directives, on parent-subsidiary dividends and on cross-border mergers, and is the basis for the proposed directive on parent-subsidiary interest and royalties.

cash transactions,⁸ or where the activity is cash-based, so that it is difficult to disentangle the ‘value-added’ element of any cash transaction.⁹ Thus, even with VAT, not every aspect of the system is as yet common to every member state.¹⁰

By comparison, the corporate tax base is not objectively verifiable. The measurement of corporate profits depends only peripherally on cash transactions. More importantly, it depends in practical terms upon the subjective judgements of accountants in arriving at commercial accounting profits and on the different adjustments that countries make to profits as so ascertained. Thus, the outcome within the EU is not one measure of corporate profits, but fifteen.

This difference between the VAT base and the corporate income base means that it is unlikely that the principle of a common corporate tax base could be captured with the same clarity as the principle of the common VAT base, as expressed in Article 2 of the First VAT Directive of 1967.¹¹ To say that the corporate income tax is a tax on corporate profits merely poses the question of how you should measure profits for tax purposes. And a further reference to corporate profits, as measured, for example, by adjusted international accounting standards, asks:

- a) how far international accounting standards are compatible with a tax base,
- b) what adjustments are in mind, and
- c) what is the extent of the regulations and directives that will be needed to specify those things?

If, despite the clarity of the VAT principle, there remain differences in the VAT bases of member states, we might wonder in what ways a common corporate tax base might still diverge between member states in the absence of a similarly clear principle for that base.

That does not mean that member states should not seek to agree a common corporate tax base or that it would be impossible for them to reach agreement on a common base. Nor does it mean that the remaining differences between member states in the practical definition of taxable profits are or would be large. Nevertheless, the division of *taxable* profits amongst the member states under a uniform formula requires the same definition of *taxable* profit in all member states.¹² The division of *consolidated commercial accounting profits* amongst member states under a uniform formula, with each member

⁸ E.g. land transactions; discounts and voucher transactions, etc.

⁹ E.g. financial and insurance services. These aspects in particular lead to cases of partial exemption and the resulting difficulty in attributing input tax to taxable supplies.

¹⁰ There may also be issues in how to administer the tax base, even if it can be objectively verified.

¹¹ Article 2 of the First VAT Directive describes the common VAT base in these terms:

The principle of the common system of VAT involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged.

On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.

¹² As well as an identical definition of the taxable entity or group whose taxable profits are being divided.

state making its own tax adjustments to its share of commercial accounting profits, does not produce a common corporate tax base for Europe, although it might represent a positive step towards a common tax base and an improvement in the current situation.¹³

In contrast to the European scenario, finding the right measure of taxable corporate profits is more straightforward in both the US and Canada. There, the federal corporate income tax offers a single definition of corporate profits as a starting point from which states and provinces can work, if they choose.

Options for progress on corporate taxation in Europe

Faced with these issues, the CEPS Task Force considered two main ideas for making progress towards a common corporate tax base within Europe. The first is the Home State Taxation (HST) idea¹⁴ and the second is an optional system of common base taxation (Optional CBT).¹⁵ Alexander Klemm looks at these ideas in Part II of this report.¹⁶

Home State Taxation (HST)

The tax base under HST is relatively clear: it is the taxable profits of the entity as determined under the rules of the entity's home state. Thus, an entity uses one measure of taxable profits only, even though every entity can in theory¹⁷ at the outset select between 15 different methods of measuring taxable profits. Although each measure would differ in its detail (at the outset at least), HST envisages that the different measures would produce substantially similar measures of taxable profits over time. This is because each member state's system would conform to agreed parameters – effectively a common corporate tax model – and member states would not be free to change their system unilaterally so as no longer to conform to that model.

Optional common base taxation (Optional CBT)

The proponents of Optional CBT do not define a common tax base but suggest that the tax base could be derived from international accounting standards, a synthesis of

¹³ This would presumably require member states to accept the consolidated reporting group as the taxable entity. I assume that it would nevertheless be possible to make tax adjustments by reference to individual companies that are part of that consolidated reporting group.

¹⁴ Originating from the Chairman's research at Leiden University and taken forward by the Stockholm Group; see Lodin and Gammie (2001).

¹⁵ Proposed in particular by Assonime, an organisation of Italian business, and amongst the proposals considered by UNICE, the federation of European business organisations.

¹⁶ Different people make different assessments as to whether it would be easier for member states to agree HST or Optional CBT and whether it would be possible to implement HST or Optional CBT in some member states if all are unable to agree. In assessing the relative economic merits of the two proposals in Part II, however, Mr. Klemm has adopted a common basis for each proposal: i.e. that if member states can agree to adopt HST then they should also be able to agree the detail of Optional CBT. Thus, for the purposes of his economic assessment, he compares HST in all member states with Optional CBT in all member states.

¹⁷ The option of all 15 would depend upon what freedom the system allows an enterprise in its choice of Home State.

taxation rules of the member state, or a combination of both approaches.¹⁸ Accordingly, the issues to be agreed in arriving at an Optional CBT seem no different from those for a non-optional or mandatory common base.¹⁹ Under Optional CBT, however, corporate entities within Europe would be allowed the choice between the common tax base and the corporate tax base (if different) defined in each member state.²⁰

Proponents of Optional CBT point out that a common tax base *parallel to* (rather than replacing) present domestic systems may assist governments to agree and implement a common tax base for companies operating in different member states. The most important aspect of this parallel approach is that governments are not required to change their domestic tax legislation (other than to allow companies with branches and subsidiaries in different member states the option of adopting the common tax base). Moreover, governments will preserve tax sovereignty over their domestic tax bases and tax rates and purely domestic companies will continue to be taxed under the domestic system.

Accordingly, member states should be more inclined to agree a common tax base than if they were seeking to define a common tax base to replace their domestic tax systems. In doing so, they will also have the support of European business, which wishes member states to address the tax issues of the single market but which fears that a common tax base *replacing* domestic tax systems may impose higher tax burdens on business and may be uncompetitive.

Formulary apportionment in Europe

Alex Klemm in Part II notes that there is no correct way (or formula) for dividing profit. This is true whether member states adopt the common measure of profit under Optional CBT or the home state measure of profit. Similarly, there is no correct way to define the unitary entity (company or group) whose profit is measured and divided. In this case, Optional CBT requires agreement on a definition of the European entity to which the common base would apply, while HST offers the possibility of extending the definition used under each member state's domestic legislation subject to agreement on some common principles.

If we assume that member states can agree a formula, as they must under either Optional CBT or HST, that formula – whatever its detail – would be a uniform one for Europe and could not be changed unilaterally by any member state.²¹ Thus, under either

¹⁸ A necessary precursor to member state agreement on these would presumably be through the use of an expert committee to examine the technical issues, as proposed in 1992 by the Ruding Committee.

¹⁹ For an indication of the technical issues, see the Ruding Committee Report in European Commission (1992), Chapter 10 and Annex 3A.

²⁰ This indicates (although it is not explicitly stated in the proposal) that under Optional CBT it is taxable profits that are apportioned to member states and not just the commercial accounting profits that then form the basis for adjustment under each member state's domestic rules. I assume that companies would be unable to opt in and out of the system over time.

²¹ To the extent that elements of any formula depended upon the valuation of particular factors, different valuation methods (or what different revenue authorities were prepared to accept as valuations) might lead to some small divergence in the application of the formula between countries. Such differences would be of a different character and order of importance as compared with the different weighting of factors permitted in the US.

Optional CBT or HST there would be both a single measure of profit per entity and a uniform formula. This compares with the situation in the US, for example, where there is a single starting point with the federal definition of taxable profit but the formulae that states apply to taxable profit may differ.

Three illustrations demonstrate how a common base and uniform formula differs from the situation in the US (common base but diverging formulae) and under HST (uniform formula but divergent tax bases):

1. A federal measure of taxable profits of 100 adopted in 15 states, each of which may choose its own formula to divide those profits. In this case, we can easily envisage a) that the choice of different formulae may lead to more than or less than 100 in aggregate being taxed and b) that each state may choose the formula factors (or weightings) in order to attracting investment to itself.
2. A single measure of taxable profits under HST where the profit figure for an entity may be 95, 97.5 or 100, depending on its choice of home state, but each of those figures is allocated under a uniform formula. In this case, the amount taxed will be 95, 97.5 or 100, depending upon the choice of home state.

In effect, a member state may choose its tax base (within the common model) to encourage companies to adopt that state as their home state.²² It has little scope, however, to define its tax base to attract investment to that state in preference to others.²³ This is because changes in its tax base extend throughout the Community for companies adopting that state as their home state and companies headquartered elsewhere can only benefit from such changes by not opting for HST.

3. Taxable profits of 100 under an agreed common corporate tax base with that figure being allocated under a uniform formula. In this case, the amount taxed will be 100 wherever the investment is made within the Community and wherever a company chooses to establish itself.

This illustrates the superiority of a common base, whether it is a *mandatory* system or the company's choice under an *optional* system. Under Optional CBT, however, member states remain free to attract investment under their domestic systems by offering more favourable measures of profits than those available under the common base. Thus, enterprises operating in states that offer taxable profits of 95 and 97.5 may decide not to choose a common base that produces taxable profits of 100.²⁴

²² It is this aspect that proponents say will encourage market-led convergence of EU corporate tax systems.

²³ The continuing ability of member states to set their own tax rate is an element of both HST and Optional CBT that may continue to affect where companies invest. The importance of the tax rate will also depend upon the factors used in the uniform formula and therefore how far different investments will result in profits being attributed to a member state with a lower tax rate.

²⁴ HST is also proposed to be optional, certainly for existing rather than new enterprises, so that companies could if they preferred continue to be taxed as at present, under the different rules of each member state in which they, their branches and subsidiaries operate. Nevertheless, the basic incentive for companies is not to opt out of HST but to choose the home state whose rules best suit their activities. It is envisaged that this would create the necessary pressure for convergence of tax bases amongst member states. This would not be convergence to 'zero' or abolition because HST envisages that member states

And the common base might be undermined if every member state were to adopt a more favourable measure of profits.²⁵

It is likely that for each company there may be a variety of reasons and different gains and losses in choosing the common base rather than continuing with 15 different member state systems, even if more favourable. If Optional CBT is successful in reducing the costs of dealing with 15 different sets of tax measurement, accounting and administrative rules, there should be a strong incentive for most companies to adopt the common system, even though from a general point of view (without considering these compliance costs) it is less favourable than the domestic tax base.

If that is correct, the advantages of the CBT in terms of simplicity, compliance costs and administration, compared to the present system, should over time be the leading force for the widespread adoption of the system and, in turn, for the convergence of domestic systems to the European common base.

HST and Optional CBT as paths to a solution

The precise economic effects of HST and of making the common base optional are almost certainly less clear than these simple illustrations suggest and, in reality, it seems likely to be quite difficult to reach a clear conclusion on their relative economic merits. Apart from anything else, any comparison of the two presents the immediate difficulty that it is easier through looking at existing member state rules to assess the likely parameters of an acceptable tax base under HST than it is to know which of those rules would be agreed upon for adoption in every member state as the common base.

In this respect, as Claudio Radaelli suggests, the choices involved in selecting *ex ante* a common tax base may not be driven by economic or 'optimal' considerations.²⁶ If, as a result, the common base were 'uncompetitive' in world terms business might not consider it a satisfactory outcome. The principal advantage of making the common base optional may then be that companies need not opt into an uncompetitive common base. This suggests that member states may be unlikely at the outset to agree on an uncompetitive system. It leaves open, however, the mechanism through which member states would agree changes to the common tax base to give it necessary flexibility as a competitive system.²⁷

establish the broad parameters of the system, and that member states will not be able to step outside those parameters.

²⁵ Member states may in any event wish to restrict the common base to companies of a certain size. In this way they would be able to maintain different systems for small- and medium-sized enterprises, reflecting the fact that the taxation of those enterprises may have to be more closely aligned to the domestic personal tax system (including that for unincorporated businesses) than a common base would imply.

²⁶ Because Optional CBT retains intact the domestic tax base, it requires (in contrast to the Ruding Committee proposals) agreement on a common tax base at the outset rather than through a process of agreement on measures that member states can introduce over time.

²⁷ This point is true whether CBT is optional or not. The option would, however, offer some incentive for member states to change uncompetitive aspects of the common base depending on the terms of the option (i.e. whether companies which had already opted-in could later opt-out). This issue does not arise under HST where the definition of the tax base remains within the competence of each member state subject to

Despite the strongly held views of members of the Task Force both for and against HST and Optional CBT, what should be remembered is that neither are proposed as ideal solutions but as practical steps towards a system that is consistent with the realisation of the single market. Indeed, consideration of the practical steps that would be needed for progress towards a European corporate tax system suggests that the differences between HST and Optional CBT are more apparent than real.

I suggest that because in seeking agreement – whether in determining the parameters of systems that qualify within HST or in drafting the Community measures needed to establish a common base – it seems quite unlikely that member states will aim to specify a single answer for every aspect of profit computation. Rather, they are more likely to agree a range of approaches, each one of which is acceptable for adoption and which, across the range, reflects the different approaches to aspects of profit computation currently found in the 15 member states. If I am correct in thinking that, the real difference between HST and a common base lies solely in their approach to implementing a common objective: the former emphasises mutual recognition at a Community level of similar (but not identical) domestic measures; the latter emphasises the adoption at the domestic level of one of several approaches agreed at the Community level to be similar. It is this intuition that lies behind the observation in Part II, that the more member state's corporate tax systems diverge, the more difficult it is to think of adopting HST or agreeing a common base; conversely, the more they converge, the easier it is both to contemplate HST and to envisage reaching agreement on a common base.

Any final assessment of the potential of HST and of Optional CBT as practical steps to a common end must include an assessment of whether HST produces convergence or growing diversity of tax bases, and whether an Optional CBT preserves the integrity of the agreement on the common base or would involve continuing competition between (and, as a result, erosion of) both the common and domestic tax bases.

What is clear is that either idea requires assessment from a variety of economic, practical and political standpoints, and in particular in terms of what member states may be able to agree for corporate taxation in Europe.

the parameters agreed at the outset. The impact of these parameters on member state actions would be similar to the current impact of the EC Treaty freedoms on member state tax systems.

PART I

THE NEW POLITICS OF CORPORATE TAXATION IN THE EUROPEAN UNION

CLAUDIO M. RADAELLI

1. Introduction

What is changing in the politics of EU corporate tax policy? What is the influence of the new global tax environment, characterised by the inclination of the OECD to crack down on harmful tax practices? What is the balance of power between member states, the European Commission and the business community in the new process designed by the European Council at Feira in June 2000? This part of the report seeks to answer these questions by means of the following five steps:

1. To elaborate on the basis of the analysis contained in the report of the CEPS Tax Force on the future of the EU tax system (Radaelli, 2000).
2. To comment on the political issues discussed by this Task Force.²⁸ For example, Onno Ruding, former Chairman of the committee of independent experts set up by the Commission in 1992 to look at corporate tax policy in the Community (European Commission, 1992), spoke to the Task Force on the economic and political issues raised by tax coordination. This spawned a lively debate among the members on the issue of voting rules in taxation (specifically, unanimity versus qualified majority voting). Further, the Task Force debated on several occasions political issues such as the potential of the OECD action to achieve concrete results in its battle against tax havens and harmful tax competition in general, the political direction of the EU tax policy process (i.e. the role of business in this process, the 'deterrence' created by the combination of state aid policy and the code of conduct, the conflicts which may arise in the implementation of the code) and, most importantly perhaps, whether the EU is effectively tackling the real corporate tax issues.
3. To assess the progress made by the EU in corporate tax policy. When the report of the CEPS Task Force on the Future of Tax Policy in the EU was released, most observers thought that the tax package proposed by the Commission to the Council (consisting of the code of conduct, the proposal for a tax directive on savings and the proposal for a directive on cross-border interest and royalties payments) was in serious danger. The political problems created by the proposal on the taxation for minimum taxation of savings appeared insurmountable. Yet the process has moved on, and important results have been achieved over the last twelve months or so. There is renewed momentum on the coordination of corporate taxes in Europe, and this report will describe and assess the new political dynamics at work.
4. To situate the EU corporate tax initiatives in the context of the OECD action. This is important because the political success of the EU policy hinges on the possibility to

²⁸ The comments presented in this part of the report fall under the responsibility of the author. They should not be attributed to the Task Force. Indeed, there were different opinions within the Task Force in particular on the issue of unanimity versus qualified majority voting in tax matters.

exploit a favourable ‘global policy environment’. This report will not deal with the details of the OECD programme, but will nonetheless assess to what extent the politics of the OECD tax initiatives has an impact on the dynamics of EU corporate tax policy.

5. Finally, and most importantly, to assess the EU corporate tax policy and to show how the proposals contained in the policy recommendations can find ‘political space’ in the agenda of the EU institutions.

Part I of the report is organised in four sections. Section 1 looks at the policy developments at the OECD level. Section 2 reviews the progress at the EU table so far, whereas Section 3 highlights the political implications and the elements of the changing political scenario of EU direct tax policy. Section 4 concludes.

2. The OECD arena: More voices in the policy process, more politicisation, more cooperation with business

Why is the OECD arena relevant for EU tax policy dynamics? Although the EU code of conduct and the OECD initiative against harmful tax practices (OECD, 1998) share different goals and cover different types of economic activity (see the analysis contained in CEPS, 2000), there are areas in which they overlap. Further, politically the EU line against ‘harmful tax competition’ benefits from a similar orientation at the OECD level. Further to the OECD (1998) report on harmful tax competition – which contained 19 detailed recommendations to combat unfair tax practices both within the OECD and in tax havens outside the organisation – a second report was published in June 2000 (OECD, 2000b). This report identifies 47 tax regimes in OECD countries that are ‘potentially harmful’. Unsurprisingly, the list includes the Belgian coordination centres and the Irish international financial service centres. Interestingly, the OECD has made the cautious political choice not to say whether these regimes are harmful or not. They are ‘potentially harmful’ – the OECD will try to assess whether they are actually harmful or not between now and the year 2003.

Jurisdictions outside the OECD were treated differently in that the OECD felt there was enough evidence to list 35 non-members as actually harmful. It is important to distinguish between the original plan of the OECD and the sequence of events that brought the Paris-based organisation to re-focus its project. The original plan was based on a tight deadline – July 2001 – for the targeted 35 jurisdictions to endorse the principles stated by the OECD. Politically, the plan was based on a couple of assumptions about power relations. One assumption was that the OECD chorus would be compact in defending the campaign against harmful tax competitions. The other was that the scattered world of tax havens would not have found the political homogeneity necessary to make their voice heard in the debate. Surely, tax havens would have used different tactics to get around the OECD imperatives. But – the OECD reasoned – they would not have been able to act together. Neither would they have found defensible arguments in the debate. The events did not quite unfold the way the OECD wanted. Although the plan was not derailed, and the press has exaggerated certain differences within the OECD countries, it remains true that:

1. The July 2001 deadline was brought forward.

2. The OECD had to re-focus the political implications of the plan. However, for the reasons explained below, we do not think that the long-term tax policy beliefs of the OECD plan ever changed between the 1998 report and now.
3. There have been signs of political antagonism coming from the world of tax havens.

These three points, however, need a qualification. After 11 September 2001, the political determination to eradicate terrorism and its financial ramifications is such that all principles of transparency and exchange of information are about to find an overwhelming support in the US and throughout the world. Therefore, certain hesitations on the OECD plan expressed by the US Treasury in the first part of the year 2001 and certain forms of antagonism coming from tax havens (and their supporters in major economies) should be re-assessed in the light of the possible tax implications of the 'war on terror'. But before we draw conclusions, let us follow the events a bit more closely.

The original plan of the OECD was that 35 jurisdictions had to express a commitment to cooperation with the OECD before the deadline of July 2001. Further to that, the uncooperative jurisdictions – this was the threat of the OECD – would be targeted by 'defensive measures'. For example, a charge on transactions with non-cooperative tax havens, withholding taxes, denial of foreign tax credit or participation exemption, and even the withdrawal of non-essential economic assistance.

In November 2000, the OECD issued a Memorandum of Understanding²⁹ with the aim of facilitating dialogue with the blacklisted 35 non-OECD jurisdictions. The memorandum provides a framework for the relationship between the OECD and the tax havens in that it establishes the steps that tax havens have to take in order to express publicly their commitment to 'transparency, non-discrimination and effective co-operation'. All 35 jurisdictions received the memorandum accompanied by a letter of the OECD. In November 2000, the OECD decided to take part in three 'regional conferences' aimed at facilitating cooperation and dialogue with offshore jurisdictions. Further to that, the Netherlands Antilles, the Isle of Man, and the Seychelles took a public commitment to reform their tax systems by the deadline December 2005.³⁰ It is not entirely clear whether this commitment will end up in significant reforms of the tax regimes in the direction suggested by the OECD. For example, some commentators noted that the Isle of Man government said that it would make the tax changes requested by the OECD 'only when every OECD nation agrees to abide by the same rules'.³¹

In its effort to collect a high number of signatures to its Memorandum of Understanding, the OECD has promoted dialogue with tax havens. An important step was taken by the so-called 'new global tax forum' created at a meeting hosted by Barbados in early January 2001. The forum includes 13 members, among which OECD nations, members of the Commonwealth Secretariat (Malaysia and Malta), the British

²⁹ See <http://www.oecd.org/media/release/nw00-123a.htm>. The text of the Memorandum is available at <http://www.oecd.org/media/MOUrev20novR1.pdf>.

³⁰ They follow other six jurisdictions (Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino) which had already expressed their intention to cooperate with the OECD.

³¹ R. Goulder, 'Centre for Freedom and Prosperity encourages Bahamas to defend tax policies', *Tax Notes International*, 8 January 2001, p. 138.

Virgin Islands, low-tax jurisdictions from the Pacific Island Forum (the Cook Islands and Vanuatu) and members from the Caribbean region. At the Barbados meeting, the low-tax jurisdictions insisted on a number of points. First, they wanted the OECD to scrap the Memorandum of Understanding, arguing that they had not been consulted before the introduction of this policy instrument. Second, the Commonwealth Secretariat asked the OECD to remove the threat of sanctions against uncooperative jurisdictions. Third, the Pacific Island Forum wanted the OECD to postpone the deadline of July 2001, arguing that time was needed to evaluate the implications of the OECD initiative against harmful tax competition and to think through the necessary steps. None of these three points was accepted by the OECD. Journalistic sources hinted that the new global tax forum raised among the blacklisted jurisdictions the expectation to be able to negotiate collectively with the OECD. But the latter responded that it was still demanding individual commitments 'rather than forge a multilateral agreement on reform'.³² Although the requests of tax havens were rejected by the OECD, the Barbados meeting signalled a change in the process. The change was political in that the OECD has abandoned the ambition of being the only voice in the process, dictating 'take or leave it' conditions to small low-tax jurisdictions.³³ The tax havens have achieved some results in terms of the process (that is, the point that dialogue and mutual understanding should be the preferred means of action), although not necessarily in terms of the outcomes of the process.

The political strength of the positions advanced by low-tax jurisdictions remains modest, but it was accompanied by the politicisation of the debate in the US. Indeed, at least up until the launch of the 'war on terror', the major opposition to the OECD plan seemed to come from pro-tax havens lobbying in the US, and the sympathetic ears that lobbyists found in some quarters of the Republican Party. A Washington-based lobbying organisation, The Center for Freedom and Prosperity (CFP), was recently established.³⁴ CFP members visited offshore jurisdictions and started lobbying in Washington in the year 2000.³⁵ Although CFP forces should not be overestimated, in the first part of 2001 its campaign raised the profile and to some extent the legitimacy of those who argue that tax competition is *always* beneficial and that there is no such thing as harmful tax competition.

'The' important issue thus became to what extent the new US administration would support the OECD project against harmful tax practices. Undoubtedly, the tax policy preferences of the previous US administration, combined with political apprehension about unbridled tax competition in the French, German, and Japanese governments, were instrumental in setting the tax agenda of the OECD. Signals coming from certain areas of the Republican camp seemed somewhat sceptical of the OECD initiative. In September 2000, the House majority leader Richard Armey wrote a letter to the then US

³² Michael Peel, 'OECD steps up tax haven drive', *Financial Times*, 19 March 2001.

³³ The point was made by R. Goulder, 'OECD, blacklisted tax havens reach landmark agreement', *Tax Notes International*, 15 January 2001, pp. 228-230. He also added: 'from this date forward, the handling of the tax haven controversy has been transplanted from inside the OECD to this new independent body [the global tax forum] at which the OECD shares an equal voice with the tax havens' (p. 230).

³⁴ See www.freedomandprosperity.org.

R. Goulder, 'New coalition strikes back at OECD tax haven campaign', *Tax Notes International*, 11 December 2000, pp. 2650-2654.

Treasury Secretary, Lawrence Summers, in which the OECD is portrayed as a 'tax cartel'. On 3 January 2001, US representative Sam Johnson, a Republican from Texas, wrote to the OECD Secretary General making the point that the OECD is focusing on the wrong problem and is using instruments that may violate WTO obligations (the reference is to sanctions that OECD members should use against uncooperative jurisdictions after July 2001). In March 2001, Armev wrote a second letter, this time posted to the new US Treasury Secretary, Paul O'Neill, describing the OECD project as 'a global tax cartel for the benefit of a small handful of high-tax nations'. He argued that the OECD initiative is 'fatally flawed and contrary to America's interests'.³⁶ A trio of US legislators, among them the chair of the Foreign Affairs Committee at the US Senate (Jesse Helms), criticised openly the OECD in their separate letters to the US Treasury.³⁷ US Senator Don Nickles, a Republican assistant majority leader of the Senate, used his influential position to argue in yet another letter to O'Neill that the 'financial protectionism of OECD nations' is 'contrary to America's economic interests' because tax competition 'keeps politicians in check and enhances economic growth'.³⁸ And a Democrat from the Virgin Islands (and Congressional black caucus member), Delegate Donna M. Christensen, stepped up pressure on O'Neill with her 12 March 2001 letter in which she argues that 'wealthy OECD should not have the right to rewrite the rules of international commerce on taxation simply because they are upset that investors and entrepreneurs are seeking higher after-tax returns'.³⁹

The combination of the new foreign policy agenda of the Bush administration⁴⁰ and the lobbying efforts described above produced a change in the US position on international tax policy in spring 2001. The new US Treasury Secretary, Paul O'Neill, appeared less sympathetic than his predecessor Larry Summers towards the OECD plan, as shown by some comments at press conferences in February and March 2001.⁴¹ In April 2001 the Chicago Sun-Times reported that US Assistant Treasury Secretary Mark Weinberger expressed doubts about the American intention to use sanctions against tax havens.⁴²

³⁶ C. Scott, 'House Majority leader, Congressional black caucus member join growing list of US lawmakers opposed to OECD tax haven campaign', *Tax Notes International*, 26 March 2001, pp. 1479-1480.

³⁷ R. Goulder, 'Trio of US legislators question OECD tax haven initiative', *Tax Notes International*, 19 March 2001, pp. 1339-1340.

³⁸ R. Goulder, 'US Senator questions OECD policy on tax competition', *Tax Notes International*, 26 February 2001, pp. 944-945.

³⁹ C. Scott, 'House Majority leader, Congressional black caucus member join growing list of US lawmakers opposed to OECD tax haven campaign', *Tax Notes International*, 26 March 2001, pp. 1479-1480.

⁴⁰ Some observers think that the lack of support for the environmental policy targets established at Kyoto shows that the Bush administration is less supportive of international policy cooperation than the Clinton administration. *The Financial Times* ('US assailed at OECD meeting', 18 May 2001, p. 10) reported that EU ministers explain the US position on both taxes and environmental policy as components of a changing US attitude towards international policy cooperation.

⁴¹ O'Neill admitted that the US position on the OECD plan is 'a complicated question'. Pressed by the journalists, he added: 'I guess I would take a pass at the moment on whether or not we [the US], as an independent entity, want to be strictly allied with what the OECD has said'. This statement is taken by Scott, 'US Treasury Secretary says US position on OECD tax harmonisation drive is a complicated question', *Tax Notes International*, 26 February 2001, pp. 943-944.

⁴² The statement was reported by the Chicago Sun-Times on 19 April 2001 (<http://www.suntimes.com>).

Eventually, O'Neill made a statement on 10 May 2001 in which he clarified the position on the OECD initiative. In his statement,⁴³ O'Neill argues that 'We have an obligation to enforce our tax laws as written because failing to do so undermines the confidence of honest taxpaying Americans in the fairness of our tax system. We cannot turn a blind eye toward tax cheating in any form. That means pursuing those who illegally evade taxes by hiding income in offshore accounts'. In order to achieve these goals – O'Neill continues – the US can use domestic tax laws, bilateral cooperation (e.g. tax treaties), and 'in appropriate circumstances, organisations like the OECD' which 'can be used to build a framework for exchanging *specific and limited* information necessary for the prosecution of illegal activity' (emphasis added).

Having expressed his qualified support for the OECD, O'Neill made three negative comments about the current plan against harmful tax practices. Firstly, the US is against 'over-broad information exchanges'. Secondly, O'Neill's statement shares 'many of the serious concerns that have been expressed recently about the direction of the OECD initiative'. The target of this negative comment is 'the underlying premise that low tax rates are somehow suspect and the notion that any country, or group of countries, should interfere in any other country's decision about how to structure its own tax system. The United States does not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any initiative to harmonise world tax systems'. This second point seems to express some sympathy towards the position of those US lobbyists and legislators who argue that the OECD plan contains the hidden agenda of raising (or at least harmonising) tax rates across the world. The third point is probably the most important one because it sets the limits of the US involvement in the OECD policy against tax havens. In O'Neill's own words, the OECD initiative 'must be refocused on the core element that is our common goal: the need for countries to be able to obtain specific information from other countries upon request in order to prevent the illegal evasion of their tax laws by the dishonest few. In its current form, the project is too broad and it is not in line with this Administration's tax and economic priorities'. Essentially, the US made clear in May 2001 that it supported the goals of obtaining more exchange of information to prevent tax evasion, but demanded a re-orientation of the project to avoid confusion on the issues of harmonisation of rates and tax systems.

In Paris, the OECD had to respond to this explicit demand from the US. It also had to counteract the fact that out of the 35 'harmful' jurisdictions, 31 had not accepted the idea of implementing the principles of a 'fair' tax world designed by the major economies. Between June and July 2001, a new position of agreement emerged within the OECD. The agreement is based on one practical step and one principle. The practical step is that the deadline for the 35 jurisdictions was extended to April 2003. This means that the deadline for the revision of potentially harmful regimes in OECD members coincides with the deadline for the non-OECD members. Accordingly, the OECD members can no longer ask tax havens to undertake reforms without putting their own house in order first.

The principle is that the OECD project is not targeting low tax regimes per se. Nor is it concerned with harmonising taxes in the world. Instead the main goal of the OECD plan is to promote the exchange of information and the necessary legal mechanisms for that

⁴³ Available on the US Treasury website.

purpose. It is important to observe that this is not a new principle. Since May 1996, when the communiqué issued following an OECD ministerial meeting endorsed the decision to fight tax degradation, not a single OECD document has mentioned such issues as the equalisation of tax rates. The 1998 report makes the clear point that exchange of information is a core objective of the initiative. Thus, the OECD plan has not been refocused in terms of principles or broad tax policy beliefs, but the emphasis has somewhat shifted from tax considerations to the wider issues of exchange of information, transparency and bank secrecy. In a sense, the OECD initiative today is ‘less tax-centred and more exchange of information-focused’ than it was in the period 1998-2000.

In light of these events, what can one expect now? The theme of fighting harmful tax competition has become openly politicised. Organisations such as the Centre for Freedom and Prosperity have sought to strike back at the OECD campaign, trying to undermine its legitimacy. Commentators speak of a ‘new coalition’, casting them in the role of the underdog David (that is, tax-competitive small jurisdictions) in his battle against Goliath (i.e. the member countries of the OECD).⁴⁴ Pro-tax competition lobbying has been intense in the US, its main goal being to have the US withdraw its support from the initiatives of the OECD in this field.

The US, however, is quite pleased with the current direction taken by the OECD project. It has also reiterated the strong support for the battle against money laundering undertaken by the Financial Action Task Force – an independent body affiliated with the OECD.⁴⁵ Cooperation and international tax enforcement have always been top priorities in the US agenda for international tax policy. The tragic events of 11 September 2001 have made the political determination to fight for financial transparency even stronger, and the US seems willing to be the major actor in this battle. Arguably, O’Neill would not make today the negative comment on ‘over-broad exchange of information’ that he made on 10 May 2001. The ‘war on terror’ may lead O’Neill to increase the US Treasury’s support for all OECD initiatives aimed at a more transparent world. Low or even zero tax rates per se may not represent a major problem in the new scenario, but tax regimes fenced by bank secrecy and no exchange of information will easily get into trouble.

The open question is whether the ‘war on terror’ will go so far as to authorise enforcement of tax laws on an extraterritorial basis and allow ‘fishing expeditions’ abroad. It is now possible to imagine a world where bank secrecy and other barriers to exchange of information are progressively demolished *if* money laundering, crime, and terrorism are involved. But the case for full exchange of information based only on tax considerations is more difficult.⁴⁶ There is also the problem created by the definition of crime: jurisdiction A may classify some forms of tax evasion as crime, and hence may wish to look through the veil of bank secrecy abroad, but jurisdiction B may not classify the same transactions as crime, and therefore may contest the right of jurisdiction A to

⁴⁴ R. Goulder, ‘New coalition strikes back at OECD tax haven campaign’, *Tax Notes International*, 11 December 2000, pp. 2650-2654.

⁴⁵ The US position on the OECD plan as it stands now and on the fight against money laundering was reported inter alia by *Tax Notes International*, 25 June 2001.

⁴⁶ See Tanzi (1995) for the various forms of exchange of information.

enforce its own definition of crime abroad. On balance, however, one should expect full agreement within the OECD members about what needs to be done in terms of financial transparency and exchange of information.

Another element that is bound to shape future developments is the confrontation between the targeted jurisdictions and the OECD members. Some of the 35 jurisdictions are in a weak position as they have been targeted both for tax reasons and for suspected money laundering (by the Financial Action Task Force). Their position in the post-11 September 2001 world is extremely weak. But the jurisdictions which are eminently concerned about tax issues may play the game with the OECD by combining forces. Indeed, some jurisdictions set up an organisation called the International Tax and Investment Organisation (ITIO).⁴⁷ The idea is to use the ITIO as a player in the dialogue with the OECD. ITIO has now sent a list of 17 questions to the OECD, seeking specific answers on matters arising from the Memorandum of Understanding and other aspects of the OECD campaign against harmful tax competition.⁴⁸ One political assumption of the original OECD plan – that is, the asymmetry of power relations between a single OECD chorus and a scattered collection of tax havens – may turn out to be wrong in that tax havens may seek to build a common front.

Considerations about time, timing and tempo are of paramount importance at this stage:⁴⁹ Will the OECD be able to break through the front of tax havens and secure the requisite number of signatures to its Memorandum of Understanding? And will OECD member states pull the trigger of defensive measures in 2003? And will the review of the OECD members' preferential tax regimes be successfully completed by then?

In any case, will the sanctions be effective? An economist has already raised doubts about the effectiveness of possible economic sanctions (Devereux, 2000). In fact, the members of the OECD have always had the possibility to take unilateral measures against small uncooperative tax havens. Thus, 'if there is a cost to taking further action which has prevented individual OECD countries from having taken it unilaterally (...), then it seems at least possible that such countries would not be willing to take such action in response to the prompting of the OECD' (Devereux, 2000, p. 13). Additionally, defensive measures such as transactional charges levied by, say, the UK on payments to Aruba, could be irrelevant if a third country acts as an intermediary in the transaction (Devereux, 2000). To be effective, defensive measures would have to be very comprehensive.

The final element of the OECD scenario can be labelled 'more cooperation with business'. This is shown by the cooperative efforts between the OECD and BIAC (Business and Industry Advisory Committee to the OECD, established in 1962). BIAC was marginalised in the early days of the OECD campaign against harmful tax competition. The Committee felt it had not been properly consulted when the OECD's 1998 report was released (see Radaelli, 2000). At that time, the positions of business

⁴⁷ At the end of April 2001, ITIO consisted of Antigua and Barbuda, the Bahamas, Barbados, the British Virgin Islands, the Cook Islands, Dominica, Malaysia and Vanuatu.

⁴⁸ C. Scott, 'Low-tax jurisdictions press OECD to answer questions on fairness', *Tax Notes International*, 14 May 2001, pp. 2411-2413.

⁴⁹ Time refers to the date when a decision is made, timing to the sequencing of decisions and tempo to the rate of speed.

and the OECD appeared far apart. Now there is a new dialogue between the two. The OECD has publicly acknowledged that it had not provided the business community an adequate opportunity to participate in the dialogue in 1998, and today welcomes a more cooperative relationship with BIAC on the topic of harmful tax competition. The new climate has resulted in the release of a joint statement by the chairman of taxation and fiscal policy of BIAC and the head of fiscal affairs at the OECD, in which they agree on the following two points:

- 1) the necessity to eliminate non-compliance with tax laws, and
- 2) the fact that the OECD should *not* attempt to harmonise tax rates, set minimum levels of taxation or curtail legitimate tax planning.⁵⁰ This rapprochement between business and government is not a phenomenon unique to the OECD arena: the EU tax policy process shows a similar trend in terms of cooperation between business and institutions.

It is to the EU that we now turn. First, however, it is useful to re-cap on the critical elements that will shape the future of the OECD 'harmful tax competition' plan. The success of the OECD plan hinges on the solution to three problems:

1. The 'focus' problem. Originally, the plan was all about attacking harmful tax competition. But now 'regulatory and fiscal transparency' lie the core of the initiative. To avoid derailment, the OECD must stick to the thrust of the project, and above all avoid confusion and disagreement about the practical implications in terms of future policy, and build on the US-driven battle against regimes which provide financial shelters for terrorism.
2. The 'credibility' problem. Credibility is undermined by the observation that the Memorandum of Understanding requires non-OECD members to go beyond the obligations of the OECD members.⁵¹ As the *Financial Times* put it (14 May 2001), to set a credible example to the rest of the world, they [the OECD countries] need first to set their own houses in order. The alignment of the deadlines for OECD members and the 35 jurisdictions is an important step in this direction. To be credible, the OECD has to show that its members are really removing the harmful components of their tax regimes. Incidentally, a number of regimes are simultaneously the target of both the OECD review and the EU code of conduct. A lack of credibility in the former forum would put the latter exercise in jeopardy.
3. The 'compensation' problem. As averred, there is scepticism over the possibility to enforce effective sanctions against tax havens. Someone has argued that the defensive measures may go against the obligations set by the World Trade Organisation,⁵² although we did not find additional evidence of lawyers questioning the sanctions on the basis of WTO obligations. The most acute problem is political. Tax coordination must include a package of compensation to small aggressive

⁵⁰ R.M. Hammer and J. Owens, 'Promoting tax competition', *Tax Notes International*, 12 March 2001, pp. 1302-1305.

⁵¹ B. Zagaris, 'Application of the OECD tax haven criteria to member states shows potential danger to US sovereignty', *Tax Notes International*, 7 May 2001.

⁵² See C. Scott, 'OECD harmful tax competition move may violate WTO obligations – expert says', *Tax Notes International*, 30 April 2001.

jurisdictions if it has to be Pareto efficient, be perceived as fair, and ultimately be successful. However, as Michael Keen (1999, p. 61) has observed, ‘explicit compensation is for some reason quite rare in international relations, and the compensation of rather prosperous tax havens for ceasing to behave parasitically seems some way from practical politics’. To solve the puzzle of compensation, the OECD needs creativity in the use of policy instruments, and, arguably, package deals that may include non-tax components.

3. The current EU strategy: Progress, ambiguity and connected games

The current direct tax policy of the EU (formalised with the ECOFIN agreement OJ C 2, 6.1.1998) is based on a three-piece tax package and a fourth element concerning fiscal state aid. The tax package includes the code of conduct, a proposal for a directive on the minimum taxation of EU non-residents and a proposal for a directive against the double taxation of multinationals. These three elements are formally bundled, which means that lack of agreement on one element makes agreement on the other two elements impossible. Let us now take a look at what's in the package.

The first element of the 1997 agreement is a voluntary code-of-conduct on business taxation (to be discussed below). The second component of the deal is the commitment to ensure a minimum of effective taxation of savings within the Community. In 1997, the Council requested the Commission to come up with a proposal for a directive and set a few points around which the proposal should be fleshed out. Following this invitation, the Commission presented a proposal for exchange of information or a 20% withholding tax on interest paid to non-resident EU citizens in May 1998.⁵³ This is the proposal that raised many objections in the City of London, worried by the possibility that capital markets would react negatively to the European tax on savings, and migrate elsewhere (Baron, 1999). Further to an unsuccessful attempt to mitigate the worries of the British delegation in Helsinki (December 1999), the EU debate has veered towards exchange of information as the best option. This would mean the abolition of bank secrecy for EU non-residents. The Feira EU summit (20 June 2000) recognised the possibility to opt for the co-existence model (that is, withholding tax or exchange of information) for a limited period of seven years, after which all countries will run a regime of automatic exchange of information among tax authorities.

At Feira, the EU leaders dropped the May 1998 proposal for the taxation of savings, but set the coordinates for a new one.⁵⁴ They agreed on a process that should lead to the approval (unanimity voting applies) of a three-piece package (a directive on the taxation of EU non-residents’ savings, a directive on interest and royalties and the full implementation of the code-of-conduct) by ‘no later than 31 December 2002’ provided that (in the area of the taxation of savings) third countries⁵⁵ implement equivalent measures and that the dependent or associated territories of EU countries (the Channel

⁵³ Proposal for a Council directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community, COM (1998) 295, 20 May 1998.

⁵⁴ The new proposal was finalised by the Commission in July 2001: Proposal for a Council directive to ensure effective taxation of savings income in the form of interest payments within the Community COM(2001) 400 Brussels, 18/07/2001.

⁵⁵ Switzerland, Liechtenstein, Monaco, Andorra, and San Marino.

Islands, Isle of Man and the territories in the Caribbean) enact the same measures as the EU member states. By 2009, all member states should switch to exchange of information as the rule for the taxation of EU non-residents' savings. At Feira, the European Council endorsed only a timetable, but, in doing so, it generated momentum for tax coordination. It also established the principle that the exchange of information (rather than withholding taxes on non-residents' savings) is the main target of the EU. Another important step was taken at the ECOFIN Council meeting of 27 November 2000, when the French Presidency secured an interim deal for those countries that – within the time limitations set at Feira – want to use withholding taxes rather than exchange of information. Austria, Belgium and Luxembourg will levy a withholding tax at 15% for three years. After that, the tax rate will go up to 20%. A regime for the so-called grandfathering of Eurobonds was also agreed. Thus some coordinates of the proposal for the taxation of savings are in place. But for the proposal to become a directive, it will be necessary to demonstrate that the third countries listed at Feira enact equivalent measures.

The third element is the proposal for a directive on cross-border payments of interests and royalties. This is a typical single-market tax measure. Conceptually, it has nothing to do with the EU fight against harmful tax competition. As such, the proposal should have been approved a long time ago. However, the three elements of the package are still linked together.

The final element concerns fiscal aids. This is an element of the 1997 agreement, although technically it falls outside the tax package that has yet to be finalised. What is the reason behind the inclusion of state aid in the 1997 agreement? Simply put, special tax regimes have too often been built under the rubric of legitimate state aid policy, thus circumventing the scrutiny of the tax Directorate of the Commission. The essential point here is the connection between tax policy and state aid policy. In a press release (23 February 2000), Mario Monti stated that the DG for competition will examine all the relevant cases of fiscal state aids in business taxation, so as to allow the Commission to comply fully and promptly with its own institutional obligations. The connection between state aids and taxation requires an examination of the progress made in the code-of-conduct. It is to the code that we now turn.

Within the current strategy to attack harmful tax competition, the code is the main instrument targeting corporate taxation. The code of conduct defines harmful tax competition. It also includes general provisions for standstill and later rollback of harmful tax regimes. A Council group (the so-called Primarolo Group, dubbed after its chair, British MP Paymaster General Dawn Primarolo) reported on the implementation of the code to the Council on 29 November 1999 (SN 4901/99). The Helsinki summit (December 1999), however, was unable to agree on the Primarolo report. The important *political* point is that while the criteria listed in the code-of-conduct were agreed by all member states on 1 December 1997, the Group's *report* was not. Consequently, reluctant member states can always rely on this area of disagreement in the process of implementation of the code. The November 1999 report listed 66 harmful tax regimes. But the report reflected either the unanimous opinion of the members of the group or the various opinions expressed in the course of the discussion. The reservations entered by some delegations to the conclusions of the Primarolo Group speak volumes on the degree of agreement on what needs to be done in the near future. Whenever Council

documents refer to the code of conduct group's deliberations, they indeed refer to broad consensus but not necessarily unanimity.⁵⁶

This ambiguity – in terms of the extent of substantive agreement among the 15 countries – may affect the implementation of the code. For example, in a progress report presented to the Council in November 2000, although all delegations agreed on the principles of standstill and rollback, one delegation objected to the specific criteria used to implement the principles. Nevertheless, the code of conduct group was able to meet every month since the European Council of Feira. Paradoxically, the group seems able to proceed in detailed analyses of the harmful tax regimes and the criteria for rollback, although the 15 countries have not resolved some fundamental issues regarding what they really want to achieve. The outcome is that at every meeting of the group there is some area of agreement, but if one scratches below the surface one finds that there is disagreement on what the real implications of the agreement are! As stated above, the code is still a component of the tax package to be agreed in 2003. Until then, member states have all sorts of ‘exit’ options if they do not want to abide by the decisions of the group. For example, if a country – possibly as a consequence of a change of government – does not want to roll back a tax regime, only peer pressure can be used to assure compliance and enforcement.

The problem of uncertainty is compounded by the relationship between the code and the state aid policy of the Commission. Technically, the Commission can decide to open a formal procedure on some of the 66 measures identified by the Primarolo Group at any time. Further, the Commission can open procedures on fiscal aids that were not covered by the code (or were covered but found not harmful) if these aids are judged in potential collision with the Treaty articles on competition policy. In a sense, the Commission received a *broad mandate* in December 1997, when ECOFIN asked the Commissioner for competition policy to re-consider state aid policy in the light of the strategy to fight harmful tax competition.

There is a big difference between a non-binding instrument, the code of conduct, and state aids, where the Commission has considerable power. However, politically the ‘arenas’ of the code and state aids are connected. The Commission gains considerable leverage from these nested arenas. Indeed, it seems that the Commission has exploited the connection between the code and state aids by using tempo (defined here as the rate of speed of decisions). When the ‘decisional speed’ in the code of conduct arena decreases, the Commission gets ready for action in terms of competition policy. When the process in the area of the code (and more generally the tax package) re-starts, DG Competition seems inclined to a prudent ‘wait and see’ policy. For example, during the months preceding the breakthrough of 27 November 2000, when the chances of making progress on the code and the tax bundle appeared low, DG Competition ‘loaded the gun’ by starting preliminary investigations on selected fiscal aids. Formal state aid procedures were not open however, to keep pressure on the national delegations negotiating in the code arena. The gun was loaded, but the trigger was not pulled. Soon after the November breakthrough, DG Competition manifested no intention to open

⁵⁶ The ECOFIN conclusions of 9 March 1998 state that the reports of the code-of-conduct group can reflect either the unanimous opinion of the members of the group or the various opinions, not necessarily unanimous, expressed in the course of the discussion.

formal procedures against the fiscal aids object of the preliminary investigation. Clearly, this is a political mechanism of threats, sanctions and rewards. Member states are rewarded for their ‘good behaviour’ at the code-of-conduct table by putting a hold on state aid procedures. Some delegations have sought to take advantage of this connection between code and fiscal aids by stating the following: in the presence of compliance with the recommendations of the Primarolo Group, a member state should be openly rewarded by DG Competition's promise not to start state aid procedures. This is clearly unacceptable: the Commission cannot make this type of deals. However, it remains true that the Commission is clearly taking into account progress and compliance in the code-of-conduct group in the formulation of its state aid policy.

Concluding on this point, the link between state aids and the code favours the Commission by giving it some political leverage in terms of threat, rewards and sanctions. An example was provided by the announcement on 11 July 2001 of a formal investigation of the Commission into 11 business tax schemes in 8 member states under Art. 88(2) of the EC Treaty.⁵⁷ This signal was certainly heard by the national delegates sitting at the code-of-conduct table.

To conclude, the state of play remains problematic. Yet there is evidence that, notwithstanding the uncertainty surrounding the Primarolo Report, and the fact that the full implementation of the code is linked to progress in the other areas of the tax policy package, the code is already generating some policy change. For example, recent changes in the Netherlands’ intermediate royalty and interest companies, advance pricing agreements and advance ruling practices have been linked to the intention of the Dutch government to comply with the criteria listed by the code⁵⁸. Should further evidence point in this direction, one should conclude that the code has acquired a life of its own (that is, the power to create domestic policy change independently of the approval of the package). At the moment, however, this conclusion would be premature.

4. New political dynamics in EU tax policy

This section provides an interpretation of the new political dynamics at work in the EU direct tax policy process. Its aim is not to predict the future, but to read and decode signals that, although relatively weak at the moment, may well give shape to the future scenario of EU taxation. The Commission provided a clear indication that it is willing to engage in a thorough debate on the future of EU taxation with the 23 May 2001 Communication on Tax policy in the European Union: Priorities for the years ahead

⁵⁷ The regimes targeted by the Commission are the following: Special Fiscal Regime for Control and Coordination Centres of Foreign Companies (Germany), Special Fiscal Regime for Bizkaia Coordination Centres (Spain), Headquarters and Logistics Centres Regime (France), Régime des Centrales de trésorerie (France), Tax Exemption on Foreign Income (Ireland), Coordination Centres Regime (Luxembourg), Finance Companies Regime (Luxembourg), Special Fiscal Regime for International Financing Activities (The Netherlands), Åland Island Captive Insurance Regime (Finland), Gibraltar Qualifying Offshore Companies Rules and Gibraltar Exempt Offshore Companies Rules (United Kingdom). There are also regimes for which the Commission is demanding specific changes in order to solve the problem of incompatibility with state aid rules. These cover Belgium – Fiscal regime of Coordination Centres, Greece – Fiscal regime for offices of Foreign Companies, Italy – Tax incentives linked to the Trieste Financial Services and Insurance Centre and Sweden – Foreign Insurance Companies Taxation Regime.

⁵⁸ See *World Tax Digest*, 91-2, 8 May 2001 and (on intermediary companies) *Tax Notes International*, 23 April 2001 (p. 2048).

(European Commission, 2001).

The argument in this section can be outlined by dint of four propositions:

1. There is a tendency to less and less legal harmonisation, that is, ‘traditional’ legally binding instruments covering all the EU countries (typically, directives).
2. By contrast, one could expect an increasing use of new policy instruments, such as the open coordination method, enhanced cooperation and infringements (this is not a new instrument, but its systematic use in direct tax policy would represent an innovation).
3. Taken together, point 1 and 2 signal a shift from a mono-thematic strategy based on harmful tax competition to a multi-dimensional strategy of tax policy convergence, in which harmful tax competition does not disappear, but is no longer the only show in town.
4. Politically, the business community has an opportunity to get back in the EU policy process, whereas the initial stages of the harmful tax competition campaign put the concerns of business at the very margins of the EU political initiative.

The voting issue: Is QMV the real issue?

Let us proceed point by point. To begin with, although proposals for EU directives are still on the table (as shown by the case of savings and interest and royalties), the future of the EU direct tax policy lies elsewhere. The inter-governmental conference (IGC) of Nice (December 2000) indicated that a possible major avenue for more directives on tax policy, that is, qualified majority voting (QMV), is not open yet. The enlargement of the EU will probably re-kindle the debate about QMV in taxation. But at least for the next four years or so there will be no QMV in taxation. Let us review the outcome of the IGC.

The Commission went to the IGC with a proposal for the introduction of QMV in the following tax domains (European Commission, 2000):

- adoption of provisions directly governing the levying of tax and aimed at preventing fraud, evasion or tax avoidance in order to eliminate cases of double non-taxation in cross-border situations and to prevent circumvention of existing provisions, particularly in the VAT field;
- adoption of coordinating provisions intended to remove a direct obstacle to the exercise of the four freedoms, and in particular to prevent discrimination and double taxation;
- measures that modernise and simplify existing Community rules in the indirect tax area in order to eliminate distortions of competition measures that ensure a uniform application of existing indirect taxation rules and guarantee the simple and transparent application of such rules;
- taxation measures that have as their principal objective the protection of the environment and have a direct and significant effect on the environment measures of coordination of social security schemes in order to facilitate the free movement of persons; and

- measures providing for minimum requirements that are necessary to allow for the effective exercise of the free movement of persons or to prevent distortions of competition through artificial lowering of social protections standards.

There was a chance of using the first point (that is, tax avoidance) in the case of the proposed directive for savings. But in any case, the IGC refused the proposals of the Commission to extend QMV in direct taxation. This does not mean that without QMV there is no future for tax directives. The Council tends to prefer an unanimous position even in decisions where QMV is possible. The mythology of the vote in the Council is false: there is now enough empirical evidence to state that the Council does not vote but rather reaches an unanimous position in a vast number of decisions technically subject to QMV. The Council does not operate like a parliament in which majority and opposition measure their respective forces by voting.

There is another reason why the insistence on QMV may be somewhat misleading. This second argument revolves around the notion that the EU is not a state and therefore a state-morphic view of the EU is inappropriate. Let us elaborate on this statement with a short digression on the majoritarian principle. In democratic political systems, the majoritarian principle is the *effect* (not the cause) of the existence of parliamentary control on government ('no taxation without representation') and of a fully-fledged political structure. By contrast, the EU has not developed along the lines of the state in Western Europe (that is, by consolidating the welfare state and the tax system in the context of the development of democratic political institutions). The EU is eminently a regulatory political system (Majone, 1996), that is, a political system specialised in the production of regulatory policies rather than distributive and redistributive policies. In this sense the EU does not fit well with a state-morphic view of the political system: redistribution and tax powers are minimal, the limited EU budget does not allow for the growth of the welfare state, parliamentary control on the executive is very constrained, and regulation is the only type of policy that can really thrive in the EU polity. To adopt a majoritarian principle in tax matters could be tantamount to putting the effect before the cause.

Additionally, regulatory policies are based on arguments of efficiency and Pareto-optimality, whereas distribution and redistribution are based on values and political preferences. The majoritarian principle does not perform well in regulatory policy (Majone, 1996). Indeed, even at the level of domestic political systems, Pareto-optimality is sought by dint of non-majoritarian bodies, such as independent agencies. The growth of the regulatory state at the domestic level has shifted the balance of power from parliaments to independent agencies, courts and experts. Parliaments and majoritarian principles are still indispensable when there are decisions to be taken on the basis of values, class conflicts or broad political options such as fairness and redistribution. But the politics of regulation involves decisions in terms of efficiency, and Pareto-optimality is not well served by the majoritarian principle. Considering that the fight against harmful tax competition is a typical regulatory policy (indeed the Commission has always made its argument in terms of the efficiency of the market), the question arises whether QMV is really the most important issue for the future of tax policy?

The code of conduct: Open coordination method in disguise?

Be that as it may, the EU is moving towards new policy instruments. The Commission remains convinced that ‘a move to qualified majority voting at least for certain tax issues is indispensable’ (European Commission, 2001:10). But it also acknowledges that ‘the legal basis will, for the present, remain unanimity’. The Commission then argues, in its 23 May 2001 Communication, that ‘given the difficulties in reaching unanimous decisions on legislative proposals, which will be compounded by enlargement, the Community should also consider the use of alternative instruments as a basis for initiatives in the tax field’ (European Commission, 2001, p.10).

The code-of-conduct represents the major innovation so far. Rather than being an odd example of policy-making, the code is a case of open coordination method in disguise (details in Radaelli, 2002). The open coordination method was introduced at the Lisbon European Council (2000) with the aim of producing policy convergence through instruments different from traditional harmonisation directives. The method is not based on law-making, but on policy transfer in that the EU becomes a catalyst and a platform for the launch of best practice. Interestingly, the method is eminently comparative: in contrast to directives, its thrust is not to impose a single legal template on to member states, but to suggest a menu of best practices arising from the comparison of what different countries are doing. Countries are supposed to exchange best practice and discuss innovative solutions to policy problems. Benchmarking, guidelines, scoreboards and timetables (rather than directives) are the main tools of the method. Peer pressure is the main mechanism for monitoring and evaluation.

Overall, the code of conduct fits in rather well with the description of the open coordination method (see the description of the code in the previous section). Turning to best practice, at first glance it seems that the code has nothing to say on this component of the open coordination method. The criteria identified by the code do not define best practice directly. By highlighting the harmful dimension of tax competition, however, they show indirectly what good practice in tax policy is. In a sense, the criteria provide a functional equivalent to best practice. The latter does not make sense in EU tax policy, where there is no idea of what the ‘best’ or ‘good’ fiscal system should be. To determine ‘worst’ practice is therefore the closest EU business tax policy can get to the open coordination method’s emphasis on best practice. On balance, the code can be considered an example of the method.

Enhanced cooperation: A new window of opportunity for tax policy development?

Another possible development of the EU tax policy refers to the provisions on closer cooperation contained in the treaties. The Treaty of Nice has introduced some rationalisation of the treatment of differentiated integration. At least eight member states must take part, but all must be encouraged to do so – the idea being that closer cooperation should assist further integration. Closer cooperation has to be employed only as a matter of last resort, hence the EU will first try to reach agreement between all member states. If agreement cannot be reached, closer cooperation becomes a possibility. The member states which remain ‘out’ must not hinder cooperation amongst the ‘ins’. However, whatever is achieved under closer cooperation will not form part of the *aquis communautaire* – an important point in the context of enlargement. The IGC

at Nice established that the national veto at the level of the European Council is abolished.

In the first pillar there will be only consultation of the European Parliament whenever ‘ins’ areas are formed in policies – like tax policy – subject to unanimity in the Council.⁵⁹ To sum up then, there is the possibility to use these new provisions for issues such as a multilateral tax treaty agreed by – say – eight countries of the Union. Commissioner Bolkestein has already instructed his officials to identify tax policy issues where closer cooperation can be employed.⁶⁰ The 23 May 2001 Communication argues that enhanced cooperation could be used in direct tax policy to go beyond the traditional forms of cooperation, namely the bilateral tax treaty (European Commission, 2001:24). There is no specific example in the Communication, but clearly enhanced cooperation provides a new pathway to policy-making in a context in which unanimity discourages an emphasis on traditional law-making.

Less harmonisation, but more action on infringements?

Another area of possible innovation is the use of infringements in tax policy (European Commission, 2001). The case of the taxation of pensions illustrates the new thinking of the Commission. In this area Commissioner Bolkestein has made it clear that the Commission will not ask for harmonisation. Yet the Commission ‘must now adopt a more pro-active strategy generally in the field of tax infringements and initiate actions where it sees that Community law is being broken’.⁶¹ This strategy has the potential to develop a tax policy aimed at striking down the barriers to the single market. The fact that the Commission is presenting its new initiatives on the taxation of pensions in terms of the needs of economic operators is an indicator of the political direction taken by Brussels. It is premature to speculate on the role of infringements in the policy process. However, it can be observed that the Commission is taking the issue of infringements in serious consideration and this is the kind of strategy that can take the Commission in directions different from the fight against harmful tax competition, specifically in the direction of a tax policy for the single market.

From a single-issue tax policy to a multi-dimensional strategy: An opportunity for the business community?

The previous discussion indicates that EU tax policy is slowly changing. Up until a year ago, the only show in town was harmful tax competition. True, the Commission put on the table other proposals – such as interest and royalties, and the comprehensive review prepared by the tax policy group in 1996 (European Commission, 1996) – but in terms of political determination all energies were focused on harmful tax competition. Now there are other elements in the EU tax policy. The lack of support for QMV, the possible use of enhanced tax cooperation, the implications of the open coordination method outside the code of conduct and the indication that the Commission may use infringements to achieve ‘single market’ goals make the picture definitively richer than

⁵⁹ New Clause G in Part 1, TEC.

⁶⁰ See *European Voice*, ‘Tax chief orders probe into treaty unanimity loophole’, 22-28 February 2001.

⁶¹ Simon Taylor, ‘Bolkestein threat to member states over tax regimes’, *European Voice*, Vol. 7(7), 15-21 February 2001.

in the past. These points were made explicit in the 23 May Communication of the Commission – a document which should pave the way for innovation in the tax policy proposals coming out of Brussels (European Commission, 2001). The Communication argues that EU tax policy ‘must, as a priority, serve the interests of citizens and business wishing to avail themselves of the four freedoms of the internal market (...) It must, therefore, focus on the removal of *tax obstacles* to the exercise of those four freedoms’ (European Commission, 2001, pp. 7-8, emphasis added).

Moreover, the Council invited the Commission to set up two panels, one on the tax obstacles to the single market and another (made up of tax experts and economists) on effective tax rates in the EU. At the moment of writing, the two panels have completed their work but the Commission has not as yet issued a communication on their results. The panels represent a channel through which the business community has been able to provide an input to the process. They have reviewed the tax obstacles faced by companies operating in the single market, the effective tax rates in Europe, and the most useful tax reforms in the light of deep economic integration in Europe. This changing scenario provides an opportunity to bring the ‘single market’ goals back into the EU tax policy. As stated in the previous report (Radaelli, 2000), a ‘single market’ tax policy should tackle the following problems of companies doing business in the Community:

- The maze of different rules for the calculation of profits;
- The need to justify prices between related and increasingly integrated enterprises as being arm’s-length prices when no comparables may be available;
- The presence of fifteen different tax authorities, which implies different administrative styles and requirements, and different approaches to cross-border tax disputes;
- The lack of a level playing field, due to differences in the tax base and dissimilarity of accounting standards;
- The inability to set losses in one country against profits in another country;
- A treaty network that is incomplete and, more importantly still, somewhat incoherent.

5. Conclusions: Balancing negative and positive integration

1. The EU institutions (Council, European Parliament, and the Commission) have made harmful tax competition the top priority in direct tax policy. The insistence of the OECD on the same theme (although with a different project) provides an element of ‘external’ support to what the EU is trying to achieve. There is uncertainty about how far can the OECD initiative go, although transparency, exchange of information, and more cooperation against financial crime are receiving added impetus from the new political climate. Preferential tax regimes and havens are used for various reasons: they will not necessarily fall under the rubric of the ‘war on terror’. However, the latter will boost all initiatives aiming at a reduction of bank secrecy. Of course, at the level of specific policy initiatives, the new international climate will not produce automatic agreement in the OECD and the EU. The example of the proposed EU directive against money laundering – which is making substantial progress but not without some differences of opinion between

the Council and the European Parliament – illustrates that the translation of high-level political commitments into practical steps takes time. Another example comes from Germany, where the government has now proposed a register of bank accounts in the aftermath of the 11 September events, but banks have raised objections. The objections relate to new instruments which may be introduced to fight terrorism, but then predestined to be employed for tax enforcement purposes. It seems that objections to the erosion of bank secrecy when tax enforcement is the only policy goals will not disappear in the near future.

2. The OECD will have more chances of achieving results if it solves the three problems of ‘refocusing’ its project in terms of practical policy implications, credibility (that is, putting the tax house of member states in order by the deadline of April 2003 before defensive measures are used against tax havens), and compensation of tax havens. Compensation requires creativity in the choices of policy instruments. There are two main implications for the EU direct tax policy. First, the EU will benefit from the renewed impetus for the OECD plan. Second, if the OECD manages to reach concrete results in its review of member states’ preferential tax regimes, this will make the code of conduct more credible and perhaps contribute to the institutionalisation of the code. Although the OECD review and the code have different goals and methods, there are areas in which they overlap. So much so that some regimes covered by the OECD forum are also the target of the code. Success at the OECD table would therefore make the code of conduct exercise easier and more credible.
3. In the EU, the attempt to crack down on harmful tax competition is based on a three-pronged tax policy package. The bundling of three different proposals is still a cause of uncertainty and problems of commitment, enforcement, and compliance but, so far, the Commission and the Council have stuck to the concept of a package. As a result, there are still some ambiguities on what the code can really achieve. The Council has not as yet discussed and endorsed the Primarolo report on the 66 harmful tax measures in the member states and dependent territories. For its part, the Commission is capitalising on the link between state aids and the code to put pressure on member states. But member states sitting at the code of conduct table have not resolved some issues as to what they really want to achieve with this policy instrument. Having said that, there is evidence that the code, although its full implementation hinges on the success of the tax package, is already having an effect in that some member states are reforming elements of their tax system with the goal of respecting the criteria outlined in the code. Domestic tax laws are also the target of the European Court of Justice.
4. These changes indicate the need for a coherent tax policy for EU corporate tax reform. Without such a policy, there will be no sense of direction in the reforms undertaken as a consequence of a) specific (hence not comprehensive) decisions of the Court and b) an instrument—the code—the results of which will be consolidated only if the full tax package is approved by the Council.
5. The question then becomes what direction is most appropriate for EU corporate tax policy? A fundamental goal of EU corporate tax policy should be to balance

‘positive’ integration – that is, market-shaping tax policies and negative integration – that is, market-creating tax policies.⁶² To understand why this balance is important, one should observe that there are two types of distortions in the single market: for simplicity, we call them tax holes and tax obstacles to the single market. The fight against harmful tax competition aims to tackle the issue of tax holes by using positive integration. The idea behind the current tax package is based on positive or market-shaping policies, that is, policies aimed at governing or directing the market. The official rhetoric in the EU fight against harmful tax competition stresses the need to curb *unbridled* harmful tax competition – a clear indication of the intention to steer a process. However, market-shaping policies (or positive integration) make sense only if a single market exists for tax purposes. Conceptually, positive integration is the step *following* negative integration. One should first strike down the obstacles to the single market (negative integration), and then try to shape or govern the undesirable aspects of the market (positive integration).

6. The negative integration component of tax policy, however, is still at best embryonic. The 1990 directives (on parent-subsidiaries and mergers and acquisitions), the 1990 convention on arbitration in transfer pricing disputes, the action of the European Court of Justice and the proposal for a directive on interest and royalty payments do not represent an adequate framework for an effective action against tax obstacles. To achieve a balance in EU tax policy, obstacles should become at least as important as tax holes. This means addressing the problems of companies doing business in the Community.
7. This balance between positive and negative integration can be achieved now that the relationships between institutions and the business community are changing. Both the OECD and the EU are more engaged in dialogue with business than in the past. Joint initiatives, policy fora, and studies are underway. The two panels established by the Commission on effective tax rates and the tax obstacles to the single market are the most important examples of the acknowledgement that a balance is needed. The Commission’s policy on tax infringements – inaugurated with the Communication on *The elimination of tax obstacles to the cross-border provision of occupational pensions* – goes in the direction of negative integration, or creating the tax conditions for the single market.
8. In terms of policy instruments, the Commission is seeking to enrich the menu of instruments used to advance tax policy. In the future, we may expect fewer directives and more flexible instruments. The use of the open coordination method, arguably, could be extended beyond the code of conduct. Indeed, it could be one of the options to consider in the reform of EU corporate taxation. The Commission may also use enhanced co-operation when a critical mass of countries (but not all of them) wishes to take a common position on tax policy. It is unlikely that enhanced co-operation will be used in areas such as the taxation of savings, but there is scope

⁶² The distinction between positive and negative integration is well-known to EU scholars. See inter alia Scharpf (1996). Perhaps one should say re-balance rather than balance: in fact, the Neumark report (1962) had already designed a fine balance between positive and negative integration (Radaelli, 1999, p. 90).

for enhanced cooperation in policies aimed at attacking the tax obstacles to the single market.

9. Taking into account the new political climate, the Commission can balance positive and negative integration, reduce the emphasis on top-down tax coordination (directives, QMV), bring the single market back into the tax picture, make political capital out of the results of the two panels, and propose the EU as a transfer platform (that is, to suggest tax instruments that those who want can adopt).
10. Finally, there is the question: What are the implications of the political analysis contained in this part of the report for the proposals discussed by the Task Force?. Of course, the reader has to read the description of proposals such as Home State Taxation (HST) and Common Base Taxation (CBT) in the second part of the report in order to understand what the issues are. Moreover, the Executive Summary is the place where the reader can find the opinions of the Task Force, whereas the individual authors take responsibility for the opinions expressed in their parts of the report. With these two caveats in mind, how can the new politics of corporate taxation affect the proposals for reform? In terms of the options discussed in the second part of the report, the first implication is that (HST) may have political appeal in the near future. By contrast, it is not at all clear whether there are political preconditions for an agreement on the optional EU base (to be employed in a regime of Common Base Taxation). HST is based on mutual recognition as major drive for convergence. HST does not require member states to agree on a common definition of the tax base – hence there is no need to seek a directive on the EU tax base. Considering the point about the limited role of directives in the future EU tax policy, this is an advantage. But there is a second advantage. By using mutual recognition to produce convergence, HST does not require member states to design the standards of the tax base first. To design the 'EU tax base' at the table of finance ministers runs the risk of setting standards that may soon become obsolete – and there is no guarantee that politicians would be motivated by criteria of economic optimality in their decisions. This is the reason why standard setting via mutual recognition is considered a superior option to ex ante harmonisation.⁶³ HST, thirdly, is fully compatible with the idea of the EU as transfer platform. Although it can be adopted by all member states, the HST proposal is compatible with an enhanced co-operation scenario in which less than fifteen member states (but at least eight) go ahead with HST without preventing the remaining countries to join in later.

⁶³ The point is made convincingly by Majone (1994).

PART II

ECONOMIC REVIEW OF FORMULARY METHODS IN EU CORPORATE TAX REFORM

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This part of the report begins by describing briefly the current system of corporate income taxation in the EU and its problems. The second section summarises reform proposals that have influenced recent political and economic debates. These include proposals such as home state taxation and common base taxation, which require the use of formula apportionment. The choice of the tax base is described in Section 3 while Section 4 deals with the choice of an appropriate formula. Section 5 further discusses reform proposals that are not based on formula apportionment and Section 6 concludes.

1. The current situation in the EU

Corporate income is taxed in every member state of the EU, but the tax rates levied and the rules for determining the tax base differ substantially.⁶⁴ For example, in 1999 corporate income tax rates (including local taxes) ranged from 10% in Ireland (for manufacturing) to around 51.6% in Germany (on retained earnings).⁶⁵ The detailed differences in the rules for computing taxable profits are many and varied but include differences in the basic rules of financial and tax accounting, in permitted stock valuation methods, in depreciation methods and rates and in the deduction of provisions, taxation of capital gains and relief for losses. Even if these differences may not in the aggregate produce significantly different measures of profits over time, they still distort business activity and investment within the Community, increase the corporate compliance burden and, in the context of this report, complicate the efforts to produce a greater degree of uniformity for the taxation of businesses within the Community.

Since the 1980s, tax rates and tax bases have converged to some extent, as most countries have undergone base-broadening, rate-cutting tax reforms. This convergence has occurred, however, without Community intervention in the form of measures to harmonise corporate taxes, in contrast to the position with value-added taxes. Indeed, European cooperation in the corporate tax field so far has been limited to the 1990 measures dealing with parent/subsidiary dividends, cross-border mergers and arbitration in transfer pricing disputes. Other proposals, for example to harmonise corporate tax systems on an imputation model or to provide a measure of cross-border loss relief, either have been abandoned or have failed to make progress. More recently, the

* The author wishes to thank Steve Bond and Jack Mintz for very helpful comments. All responsibility for errors remains the author's.

⁶⁴ The interaction between corporate and personal income taxes also differs to a great extent. This potentially affects firms' decisions on how much of their earnings to pay out as dividends, depending on where their marginal shareholders are resident. Although this may be a very important issue, it is not considered in this report, which focuses on taxation at the firm level.

⁶⁵ Source: Bond et al. (2000). These typical rates include sub-federal taxes where appropriate.

‘package’ of measures, comprising the Savings Directive, Interest and Royalties Directive and the Code of Conduct on harmful tax competition, has made progress and secured a measure of cooperation between member states on certain direct tax issues. In essence, however, the integration of corporate income tax systems between EU countries is not significantly more advanced than is the case between EU and most non-EU OECD countries. Furthermore the treaty network between member states is not even complete and the terms of existing treaties are not necessarily identical. There is as yet no EU model treaty for use between member states, although member states generally use the OECD model for their treaty negotiations.

On the other hand, the increasing integration of the single market and the adoption of a single currency are exerting greater pressure on the relationship between member state tax systems than is the case in their relationship with third countries. In addition, the European Court of Justice has increasingly been called upon in recent years to adjudicate the relationship between the member states’ tax systems and the ‘freedoms’ established by the EC Treaty, thereby requiring some degree of uniformity of approach (albeit short of actual coordination) to cross-border direct tax issues. The European Commission has also given notice of its intention to be more pro-active in the use of the EC Treaty State Aid provisions in the direct tax field.

Nevertheless, the implication of the existing situation for multinational firms operating in more than one European country remains that profits must be calculated individually for each country in which a firm has a permanent establishment or subsidiary. A firm that operates in two European countries therefore has to use separate accounting (SA), just as a firm operating in two countries of which one is not a member of the single market. To facilitate separate accounting, every transaction between related entities within a multinational group must be recorded and charged. Furthermore, to ensure an accurate allocation of taxable profits between related entities (and to prevent the manipulation of profits between them for tax advantage), the tax law of member states requires the use of arm’s length prices, i.e. prices that two unrelated parties would charge each other.

The introduction of corporate income taxes predates the creation of the European Community in all EU members. It would be unsurprising, therefore, if the current system of separate accounting with arm’s-length prices were found not to be an ideal solution for a single market Europe or in fact any group of countries whose economies are highly integrated. The increasing integration of the European economies has indeed led to a number of problems, which will be briefly summarised in the following section.

1.1 Problems of SA in integrated economies

Problems in calculating or monitoring transfer prices

Most of the disadvantages of SA arise from the difficulty in determining arm’s-length prices. Frequently, arm’s-length prices cannot be determined objectively or may even not exist at all. The former problem arises for example when the price of a good that is available in a range of qualities needs to be estimated. In that case there will be many different market prices for that good, and the determination of the right price dependent upon quality could be administratively costly. Monitoring such transfer prices will also be difficult for tax authorities. The latter problem may occur when intangibles are traded within a company. If a subsidiary pays licence fees for a patent held by its parent, then

there will be no market price available at all, unless the patent is also licensed to unrelated firms. For multinationals these problems are likely to be very common. After all, the economic rationale for integrating international operations into a multinational group is that this is more cost-effective in some industries than trade between unrelated firms. In such industries it is therefore possible that there will be no unrelated firms trading an intermediate good, even if the good is in principle tradable.

The administrative costs incurred both by the multinationals and the tax authorities in order to calculate and monitor transfer prices are not the only problem. More importantly to the revenue authority in absolute tax terms, multinational firms can use transfer pricing, the location of borrowing and other methods to shift profits to low -tax jurisdictions and thereby decrease their overall tax liability. As an important part of transactions in modern multinationals involve intangibles or qualitatively heterogeneous products, the scope for such profit shifting can be large. On the other hand, firms that are investigated for manipulating transfer prices may suffer double taxation of profits even though their prices were calculated in good faith, if the tax authorities of one state make an adjustment for which the other state will not agree a corresponding adjustment. In this respect, achieving mutual agreement on transfer pricing adjustments may be further complicated if two countries' tax authorities use different rules to estimate transfer prices.

So far this problem has been tackled by devising international rules for transfer pricing, currently embodied in the OECD's 1995 Transfer Pricing Guidelines. Two things can be noted about these rules: First, the Guidelines do not produce a single method for measuring arm's-length transfer prices but embody five 'approved' methods of doing so. This reflects the variety of circumstances in which it is necessary to calculate a transfer price but the fact that so many 'approved' methods exist (leaving aside other 'unapproved' methods) illustrates how arbitrary the process is and means that there remains scope for disagreements. Second, two of the methods (the Profit Split Method and the Transactional Net Margin Method) involve methods or factors that are not directly related to the good traded, but instead give an indication of where the profits originate. These rules therefore approach a system in which profits are allocated by formula rather than objectively determined arm's-length prices. Such systems are discussed in more detail below.

Restrictions on cross border consolidation

Under SA, multinational firms cannot consolidate their European profits for tax purposes. This is especially problematic if they incur losses in some countries. If foreign operations are organised as subsidiaries, it is almost never possible to set off losses incurred by a subsidiary in one country against the profits of the parent or subsidiaries based in other countries.⁶⁶ If foreign operations are organised as branches, some set-off of losses is generally admitted between the branch and headquarters. This provides an incentive to set up foreign operations as branches, if losses are expected. This may be inefficient, if the optimal operational structure according to business needs would have been different. Furthermore losses often cannot be set off completely even if operations are organised as branches. This is especially worrying as it may often affect firms in the

⁶⁶ Only Denmark and France allow a degree of relief in such circumstances.

process of expanding into other European countries. If their operations are expected to be loss-making in the first few years, then the impossibility of obtaining full relief for such losses effectively discourages their expansion. If this is a common problem, then this is a barrier to the full establishment of the single market.⁶⁷

Administrative and compliance costs

Apart from the administrative and compliance costs that are due to the determination of arm's-length prices, there will more generally be costs due to the existence of different tax authorities in each country. The administrative costs to the governments are probably much higher than running a common agency. Firms will face compliance costs having to deal with different tax systems and their rules. Such costs arise because the multinational needs to employ tax advisers familiar with the tax laws of each country. Further costs arise to the extent that different financial and accounting records have to be produced to facilitate the computation of taxable profits and to ensure compliance with the tax code.

1.2 Other issues that arise in case of tax reform

Any suggestion for tax reform should aim to address the problems that have arisen due to the ongoing integration of the European economies. A reform however offers as well the opportunity to re-evaluate more generally the effects of the taxation of corporate income.

Before discussing any reform proposals for corporate income taxation, it may be useful to consider why corporate income should be taxed in the first place. The incidence of such a tax is always borne by individuals such as the firm's employees, the owners of its capital and its consumers. It should thus be possible to tax these individuals directly rather than with a corporate income tax. The main reason for applying a corporate income tax is that it serves as a withholding tax for the income of capital owners. This is especially important for the otherwise untaxed income of inward investors. There are a number of other commonly stated, but more disputed reasons for taxing corporate income, e.g. that corporate income taxes serve as a charge for the use of public goods, the limitation of liability or economic rents. The latter three arguments are especially needed if double taxation of income, i.e. at the company and shareholder level, is to be justified. Such a system of dividend taxation is called a classical system. In Europe imputation systems are more common and double taxation occurs to a more limited extent.⁶⁸

The main function of the CIT in Europe is thus to provide a withholding tax. The difference between a corporate income tax and a withholding tax levied on dividends is that retained earnings would not be taxed under the latter. Taxing corporate income is thus unavoidable if the aim of the tax system is to tax income comprehensively. Under a

⁶⁷ This problem may be alleviated if firms can manipulate transfer prices in order to shift their profits. Even in such circumstances, however, such manipulation remains open to the risk of adjustment by revenue authorities under their transfer pricing rules.

⁶⁸ Strictly speaking most EU countries do not have full imputation systems, but rather partial imputation or other shareholder relief systems, in which only a partial allowance is made for taxes paid at the company level.

consumption tax on the other hand, corporate income taxation would not be necessary anymore. The debate about whether a consumption or a comprehensive income tax is to be preferred is unresolved and cannot be analysed in great detail in this report. Instead the assumption is made that EU countries will continue to attempt to tax income comprehensively, at least to some extent.

Under the assumption that countries do not want to abolish corporate income taxes, what factors should they consider in implementing the tax?

Economists often stress the desirability of neutrality. A neutral tax is a tax that does not affect investment decisions. Under neutral taxation, any project that has a pre-tax present discounted values (PDV) greater than zero, i.e. that it is worthwhile to undertake, would also have a positive post-tax PDV. An example of such a tax is a cash-flow tax. One version of such a tax allows the immediate expensing of capital investments, but does not allow interest payments to be deducted. Currently the corporate income taxes adopted by member states are clearly not neutral. A marginal project, i.e. one in which the pre-tax profit is just high enough to satisfy the providers of capital would typically not go ahead, as such profit would be diminished by taxes. This is because not only the economic rents of investments are taxed, but also normal profits, i.e. the normal returns to capital. There are further complications due to the deductibility of interest but not dividends. Given that current corporate income taxes are not neutral, a reform that leads to another non-neutral system can still be an improvement and should thus not be ruled out on that basis.

Even if a tax system is not completely neutral towards investment, there is still an issue of whether it is at least neutral towards the *location* of investment. This can be determined with the help of two concepts: Capital import neutrality (CIN) and capital export neutrality (CEN). Under CIN, companies investing in a given country face the same level of taxation irrespective of where they are officially resident. This would be the case under separate accounting, provided profits are determined correctly and taxation is purely source-based. If taxation is residence-based, then clearly companies from different countries face different tax levels and CIN does not hold anymore. In that case, however, there is CEN: investors originating in a given country face the same tax levels irrespective of where they invest. Their investment decisions will thus be based on factors other than the details of the corporate income tax system of the country in which they invest.

In the EU currently none of the above hold, as some EU countries use source-based taxation, while others use residence-based taxation. Furthermore, no country uses purely source- or residence-based taxation. Instead, countries compromise on these ideal types. Countries applying a residence-based system for instance typically do not attempt to tax profits unless they are repatriated. Countries that exempt foreign source income usually have special provisions for income from tax havens. For the functioning of the single market CIN may be the more important point, as European firms should face the same tax burden, irrespective of where their headquarters are based. Violations of CEN on the other hand can even be efficiency enhancing if they represent different levels of public good provision in different countries, and hence should be taken into account when investment decisions are made.

A different issue is tax competition, which has recently attracted much attention both in the EU and at the OECD level. Tax competition is not a clearly defined term, though. Often a distinction is made between ‘harmful’ and legitimate tax competition. Harmful tax competition refers mainly to tax havens and special tax regimes. As this is not really a result of the corporate income taxes in Europe, and because there are already other initiatives (such as the EU’s code of conduct group and the OECD’s on-going work) aimed at this type of tax competition, it will not be dealt with here.

More generally tax competition refers to the possibility that, due to the mobility of capital, there may be downward pressures on the level of taxes that can be raised from corporate income. In the most basic models of tax competition this process leads to the under-provision of public goods and is thus detrimental to welfare (e.g. Wilson (1986) or Zodrow and Mieszkowski (1986)). This result, however, is extremely sensitive to the assumptions made and there are other models that show that tax competition can be welfare improving, e.g. if governments are not assumed to be perfect welfare maximisers (e.g. Edwards and Keen, 1996). Another possibility is that some countries can export some of the tax burden to non-residents and therefore choose higher than optimal tax rates (e.g. Bond and Samuelson, 1989).

Most economists would probably agree that the theoretical results so far are not very robust. Empirically too the issue remains unresolved, although it seems clear that a complete collapse of corporate tax revenues, a process often called ‘race to the bottom’, has not yet occurred. Despite all ambiguities, the sensitivity of the tax system to tax competition should be analysed under the different reform proposals. If a reform increases the scope for tax competition then this would probably be seen as a weak point by most economists, either because of welfare losses (e.g. due to under-provision of public goods), or because of the fiscal externalities introduced. Economists more concerned about Leviathan-type bureaucratic governments would however welcome such a result.

Finally, any proposal needs to be examined as to whether they can be easily adopted by countries wishing to participate later. This is important because of the expected further enlargement of the EU. Furthermore, it is possible that not all countries will immediately agree to implement a proposal, just as in the case of the introduction of the single European currency.

2. Recent reform proposals

This chapter briefly summarises reform proposals for EU corporate income taxation. Whenever reference is made to the EU, it should be borne in mind that the area in which a proposal is applied may be a sub-group of EU countries.

2.1 European corporate income tax (EUCIT)

An obvious, though drastic, reform proposal is to replace the current country specific corporation tax systems by a single European corporate income tax. Tax revenues under such a tax could either be collected centrally, or be distributed to the member states’ ministries of finance. In the latter case a formula would be needed to apportion the tax across member states. The need for such a formula is a feature of most of the tax reform proposals, though usually to allocate profits rather than taxes. A formula usually uses

one or more so called ‘factors’, e.g. the capital stock, so that the tax base or the taxes are allocated according to the distribution of the factor or factors. If more than one factor is used, the formula specifies how to weight each factor.

While this proposal has been the subject of academic debate the political and institutional framework of the Community would be unlikely to support such a solution in the foreseeable future. A number of countries have already stated their opposition to any attempt to harmonise European taxes. It thus seems safe to assume that this proposal, which requires the abandonment of existing corporate income taxes and the production of a newly harmonised version is doomed to failure in the current political climate. The analysis of EUCIT in this report is accordingly brief.

2.2 Common base taxation (CBT)

Common base taxation is a system in which all participating jurisdictions agree on a common definition of the tax base and allow (or oblige) companies to calculate consolidated profits using this common base. Such a system was recently proposed by UNICE (2000). Its proposal was to introduce CBT as an option, so that companies can choose whether to continue preparing up to 15 separate profit calculations under separate accounting or calculate instead consolidated profits using the common European definitions. How the common base would be defined is not elaborated in any detail in the proposals.

An important difference between CBT and a EUCIT is that countries still set their own tax rates under CBT. Only the definition of the base and a formula to apportion the tax base to separate countries need to be agreed upon by participating jurisdictions.⁶⁹ How the part of the base that is apportioned to any given jurisdiction is taxed, is then up to that jurisdiction to decide, provided that this is done in a non-discriminatory way.⁷⁰

2.3 Home state taxation (HST)

Home state taxation allows firms to calculate consolidated profits according to the rules of their home state. As under CBT these profits are allocated using formula apportionment and taxed at each jurisdiction’s rate. The difference however is that there will be no commonly agreed definition of the tax base. Instead jurisdictions agree to mutually accept each other’s definition.

This proposal is based on the assumption that taxable profits would be similar across jurisdictions, even if specific rules may differ. The idea behind this assumption is that each jurisdiction has to make arbitrary decisions as to how to treat different components of profit calculations. It may matter little whether one of these components is treated

⁶⁹ It is not strictly speaking necessary to agree on a common formula, although it is strongly advisable. See Section 4. for a discussion of this issue.

⁷⁰ It is also possible, both in the case of CBT and EUCIT, to allow countries to offer tax credits. A country that wished to encourage a certain activity could thus offer a tax credit for firms investing in this activity, rather than changing the tax rules, e.g. via accelerated depreciation. Such tax credits would then be deductible against the tax payment made to the revenue authority of the country offering such credits. If that option is chosen, then countries would keep some influence on their tax policy even if tax rates are the same. It is a way to allow countries in effect from deviating from the common base, without having to change the common definition of the base.

more favourable in another country, as long as this is outweighed by less favourable treatment of another component.

2.4 Abolition of corporate income taxation

Corporate income taxes currently raise on average 8.7% of the total tax revenue in EU countries. This amounts to about 3.5% of GDP.⁷¹ Assuming that countries would want to compensate for such a loss in tax revenues, some other taxes would need to be raised or new taxes introduced over time. Therefore any efficiency gain will have to be weighed against the efficiency cost of compensatory taxation. Alternatives that are often mentioned are to move towards the more comprehensive or higher taxation of value added or to tax inputs, such as capital directly. Alternatively, higher taxes could be raised from other sources such as labour income, although this would be contrary to the desire expressed by the member states to reduce the burden of taxes on labour income and maintain taxes on capital.

3. The definition of the tax base

The common approach of EUCIT, CBT, HST and related proposals is to allow (or force) companies to calculate consolidated profits across the EU. These profits (taxes in the case of EUCIT) are then apportioned using a formula to participating jurisdictions within the EU. There are a number of issues that arise equally in all of these proposals. This chapter will first examine those common issues and then discuss the differences between the systems.

3.1 Common features of EUCIT, CBT and HST

Consolidation of profits

The first issue that needs to be addressed is at what level should profits be consolidated? Should subsidiaries be treated any differently from branches?⁷² A possibility is to use the concept of ‘unitary combination’. This concept is currently used in some US states. Exact definitions vary from state to state,⁷³ but the general idea is to include in a unitary group all units of a company that form part of the same business, irrespective of whether they hold a separate legal identity.

While the idea behind the concept is simple, it may in practice be quite difficult to determine whether two business units form a unitary group. As one of the aims of reform is to reduce the administrative burden, it is absolutely essential to find a definition that can be easily understood and applied. Unfortunately most simple definitions fail to do justice to the concept. For example, a rule stipulating that all units

⁷¹ Source: OECD (2000). The averages reported are simple arithmetic averages, based on 1999 data (the means are the same for 1998). Corporate income tax revenues as a percentage of total tax range from 4.1% in Austria to 17.4% in Luxembourg. As a fraction of GDP tax revenues range from 1.8% in Germany to 7.3% in Luxembourg.

⁷² This discussion does not only apply to the EU but also to individual countries, not all of which (e.g. Italy) currently allow for the consolidation of group profits and losses.

⁷³ States differ also in that some only allow unitary combination while others require it. Furthermore some states do not restrict unitary combination to US activities of a business (the ‘water’s edge’), but allow, on a voluntary basis, overseas activities to be combined as well. See also discussion in Section 3.3.

in which a company holds at least a 50% interest are included would count a subsidiary that is not integrated into a group's operations, but exclude business units that are under the effective control of a company, even though it holds less than 50% of its capital.⁷⁴ In practice therefore rules will have to be more complicated and take account both of ownership and control.

The implementation of unitary combination in the EU may be more difficult than in the US, as the corporate structures in some member states are comparatively complicated, e.g. there may be cross-holdings, pyramidal groups, etc. An advantage in Europe would be that the rules could be determined centrally, so that unlike in the US, the definitions would be the same in each jurisdiction.

Unitary combination is not a requirement of formula apportionment. Canada for instance does not use the concept of unitary combination and requires each subsidiary to file independent tax calculations. Nevertheless, the case for applying unitary combination in Europe is strong. After all, it is one of the aims of the reform proposals to improve the opportunities to set off losses against profits. Unitary combination allows that set-off irrespective of the legal structure of a company's units. The legal structure can then be determined according to the company's business needs. Furthermore the problems of determining transfer prices are not restricted to branches; in fact, subsidiaries are the more common structure of European companies' foreign European operations.

Finally, without unitary combination, a company can in effect choose between which of its business units it wants to consolidate accounts, by choosing to set up some of them as branches and others as subsidiaries. Thus, loss-making activities, especially in high-tax countries would be set up as branches, while profitable activities in low-tax countries would be set up as subsidiaries. In that case the scope for profit-shifting would increase as compared to the current situation, although it is already common planning to establish as a branch initially when losses are anticipated and then convert to a subsidiary.

All of the systems discussed in this chapter do away with separate accounting, although some of them only on an optional basis. For those companies that participate, there will be no need anymore to determine arm's-length transfer prices and consolidation will be fully available. This would also mean that intra-company dividends and royalties would have to be tax-free, as dividends currently are within member states.⁷⁵ This latter point could however also be achieved by measures such as the proposed interest and royalties directive.

⁷⁴ See McLure and Weiner (2000), pp. 262 ff. for further details. They also provide a summary of legal tests of unitary combination in the US and provide further references.

⁷⁵ If dividend and royalty payments within the EU are not taxed, it may be advisable to introduce a common tax treatment of dividends and royalties between EU countries and the rest of the world. Otherwise all income originating outside the EU would be channelled through the countries applying the lowest tax rates. Dividends and royalties paid to non-EU residents would be paid from the country applying the lowest withholding rates. Alternatively a group could be required to use its home state's rules (see discussion of choice of a home state).

Administrative issues

The main administrative advantage for companies adopting any of these proposals is that for tax purposes only one consolidated profit calculation needs to be made instead of up to 15 separate ones. Only one set of rules needs to be followed rather than up to 15 different ones. The administrative implications for tax authorities are less clear. In case of EUCIT and CBT, tax authorities would have to learn to use and monitor new rules, which at least in the first few years would require substantial investments in training of their staff and possibly in updating computer programmes. In contrast to companies these costs for tax administrations cannot be weighed against the advantage of not having to deal with 15 systems anymore. Furthermore tax authorities would have to start accepting evidence, such as invoices, contracts, etc. in any of the European languages. Checking foreign documentation for fraud is likely to be much more difficult and onerous than domestic documentation, so that cooperation among tax authorities would need to be improved. It should be noted, however, that the correct calculation of arm's-length prices also requires such cooperation. The administrative gains for companies are especially high if present definitions of tax bases differ substantially across the regions in which they operate. Unfortunately this would exactly be the case in which it would be difficult for participating jurisdictions to agree a solution.

Separate accounting vs. CBT and HST

Given the difficulties of separate accounting it may seem surprising that it is still the norm across the world. There are a number of reasons for that, the main one probably being that, if arm's-length prices can be accurately computed, separate accounting is superior, in the sense that it reveals accurately where profits arise. No formula can ever be more than a rough guide for the location of profits. This can be seen by thinking of a company that operates in two jurisdictions, but at different levels of profitability. Whatever formula is used, as long as it is based on inputs and sales, it will not reveal the fact that the profitability is higher in one jurisdiction and that jurisdiction will thus lose revenues compared to the separate accounting case.

This is not just a theoretical curiosity. Empirical studies (e.g. Shackelford and Slemrod, 1998, and literature cited therein) have shown that using formula apportionment internationally (i.e. not restricted to a region, such as the EU) would lead to increases in US tax revenues. Shackelford and Slemrod estimate increases in tax revenues of up to 38% assuming that tax rates remain constant. They point out that this could be caused by higher profitability of non-US operations, or by successful profit shifting. In any case, this shows the difficulties of using formula apportionment in an international setting. If countries believe that they will lose tax revenues to foreign jurisdictions, they will be very unlikely to accept such an agreement. As taxation is a reflection of each country's sovereignty, it is hard to see why elected representatives should opt for such a system. This is particularly the case if tax revenues were affected by real differences in profits, rather than profit-shifting. Side-payments could not easily solve this because countries gaining revenue would probably take the view that the new system is fairer. Furthermore, these would have to be frequently negotiated, as differences in profitability probably do not remain constant.

Within a federal state these issues do arise, but to a far lesser extent. First, the bulk of corporate taxes usually go to the federal government anyway. Second, the federal

government often helps out states that have lower tax revenues. Third, there may well be more confidence in the appropriateness of the outcome across federal states than across nations. A federal state might not be as concerned if 5% of its corporate tax revenues were attributed to one of its neighbours as, say, France would be if 5% of its revenues were apportioned to the US. In fact such a situation has already arisen when the state of California attempted to introduce compulsory world-wide unitary combination. These attempts were countered by legal challenges by European firms and strong criticism by a number of European governments and the European Commission.⁷⁶

For formula apportionment to work in the EU, a necessary premise would be that member states trust each other to the extent of accepting any loss of tax revenues. This may be possible if the overall gains are seen to outweigh any such losses. The extent to which such redistribution of tax revenues can be avoided by choosing tax rates is discussed below.

Should the new tax system be optional?

HST and CBT are both put forward on an optional basis for companies rather than as compulsory reforms.⁷⁷ Companies which prefer to continue using separate accounting will thus be allowed to do so. This has a number of implications for economic and administrative efficiency.

- Tax revenues are likely to decrease, as companies will only adopt the new system if they expect to pay less taxes under the new system (unless their administrative gains outweigh higher taxes).
- The incentives for the adoption of the new system are problematic: Those firms that gain most from profit-shifting through the manipulation of transfer prices are the ones that are least likely to adopt the new system. This could be countered by applying tighter rules for the determination of transfer prices for those companies that prefer to continue using SA.
- Administrative gains are likely to be lower if companies choose to prepare two profit calculations in order to find out which system is more generous for them. On the other hand, administrative costs due to changing the internal accounting system could be avoided by companies for whom these would be extremely high (e.g. SMEs). Revenue authorities would have to continue operating both systems.
- Differences in the tax burden between companies would increase, if only some companies took up the new scheme. This would result in different firms in the same business using different tax rules, e.g. because their parent companies have different characteristics that make adoption of CBT worthwhile only for one of them.

These disadvantages are somewhat mitigated because under both proposals firms will have to make a binding choice as to whether they wish to adopt the new system. This

⁷⁶ For more information on this case see e.g. McLure and Weiner (2000) and literature cited therein.

⁷⁷ For the proponents of CBT, the optional nature of the proposal is said to be fundamental to its acceptability to the corporate sector and a necessary feature enabling member states to agree a common base. In the case of HST, the optional nature of the system is essentially a transitional feature to enable companies currently operating across Europe to manage their entry into the system.

choice cannot be changed year by year depending on the level of tax liability under both methods. Still the economic case for making the new system optional seems to be very weak. Nevertheless this may be a good interim solution in an imperfect world. As revenue and economic effects of tax reforms are extremely difficult to predict, making the system optional would provide an opportunity to evaluate the system and to adjust based on experience. Once the system is working well, i.e. tax revenues are at the desired level and cooperation between tax authorities has been established, the new system could become compulsory for all European multinationals. As the proposals made are based on optionality, however, this feature will be assumed for the rest of this report.

Residence and source-based taxation

As mentioned above, some EU countries currently tax world-wide income while others exclude foreign source income, both subject to exceptions. For income originating in other EU countries, under EUCIT both possibilities would amount to the same. A residence-based country will not exclude foreign EU profits, but the taxes owed will be exactly identical to the deduction for taxes paid. Under CBT and HST, residence-based countries could still tax the foreign source income, if tax rates abroad are below home tax rates. The calculation of such taxes would be extremely easy, as the tax base would simply have to be multiplied by the difference in tax rates. Nevertheless, it will be assumed in this report that residence-based countries will not attempt to claim taxes on EU profits anymore. It would run counter to the spirit of an agreement such as HST or CBT, if a country taxed more than the share apportioned by the agreed formula.

The difference between source and residence-based taxation remains with respect to foreign source income originating outside the EU. Such income would have to be allocated to a country; either the home state of a firm, or the state in which the subsidiary resided that receives the income. Then it would be either taxed or exempt, depending on the rules of the country to which it is allocated. Once it has been taxed (or exempt), the firm can retain it to finance investments or pay it out as dividends. There is thus a strong incentive to receive such income in countries that exempt foreign source income (unless the taxes paid abroad are higher anyway). This could thus influence the choice of which subsidiaries receive foreign source income or the choice of the home state (see below), depending on which rule is used (see also footnote 75).

3.2 Differences between the proposals

The main practical difference between HST and CBT is that under the former system firms will follow their home state rules for the calculation of profits (resulting in different rules for firms based in different home states) while under CBT, all firms that opt for the new system face the same rules. This section examines some of the economic, administrative and other effects of this difference.⁷⁸

⁷⁸ In making these comparisons, however, it should be borne in mind that it is an assumption of the HST proposal that member states are unable to agree immediately on the rules of a common base. The 'choice' between HST and CBT therefore does not exist in the ordinary sense of a choice between alternatives. If it is correct that member states would be unable to agree immediately on common base rules, therefore, the issue is whether it would be better to adopt other incremental approaches or do nothing, until such

Choice of location

A firm operating in the EU faces a number of location choices. It needs to choose a state as its home state, and locations for production, sales and other operations. The first of these choices will differ depending on whether CBT or HST is introduced. The latter are not affected by the difference between CBT and HST, although they will be affected by the formula used to apportion tax revenues across jurisdictions, the tax rate and any local tax credits (if allowed). EUCIT is completely neutral towards the choice of locations, unless the concept is compromised by allowing regional tax credits, subsidies or taxes. Under HST the home state is important because its rules are used to determine taxable profits. Under CBT the home state is of much lesser importance because it will affect taxation only to the extent that head office operations will lead to the apportionment of some of the profit to the home state.

A related issue to be resolved is whether companies face free choice over which country will be their home state or whether there should be parameters within which the determination must be made. Free choice of home state may not seem sensible if that allows firms to choose countries on the basis of the tax advantages they offer even if they have only marginal operations there. On the other hand, free choice may seem fairer to companies, as no company would be at a disadvantage just because it had previously chosen to locate its headquarters in a particular state.⁷⁹

A precondition for HST to be feasible is that tax bases do not differ significantly amongst participating countries. Otherwise firms residing in countries with comparatively broad definitions of taxable income (and a lower tax rate) will face a higher tax burden when profits are allocated to other countries that adopt a narrower tax base and higher tax rate. This will seem unfair the companies concerned (unless they can freely change their Home State) and to their home countries. Currently, there are quite substantial differences in the detailed definitions of taxable profits between countries. Differences in the tax burden, however, are not always that large because countries with broad definitions of the tax base may have lower tax rates (see footnote 82). Also over time tax bases have not been constant. Many EU countries have undertaken base-broadening rate-cutting reforms over the last two decades. Under HST, if countries compete for the location of headquarters, there would be incentives to take these reforms back. A country that decides to increase its tax rate and to narrow its base in a revenue neutral way, will become a more attractive one to locate a company's headquarters. This will be mitigated, however, if countries compete simultaneously for the location of production because this will be affected by the tax rate imposed.⁸⁰ In

time as agreement on a common base is feasible, rather than seek to adopt HST as an incremental or transitional measure itself.

⁷⁹ One way to achieve convergence within Europe would be allow free choice. Companies can then be expected to choose their preferred state, whose tax system will become the basis of a harmonised EU system. This corresponds to the US experience with company law: each state has its own company law and there is no US company law, but in practice Delaware has become the prevailing company law system of choice. While such an approach circumvents the need to agree on a common base, there is a risk that the rules used by the state favoured by companies would not be regarded as the best possible rule by the majority of experts and policy-makers.

⁸⁰ At the risk of speculating too much, it may be conjectured that a possible outcome would be that some countries, e.g. very small ones, will specialise in offering competitive tax rules for the location of

order to avoid such competitive pressures, a certain degree of conformity in the definition of the tax base thus seems necessary to avoid large differences in tax liabilities for similar companies that are registered in different home states, and to prevent inefficient competition across member states.⁸¹ A further complication arises if a country's rules differ according to the industry in which a company operates. For conglomerates there could then be incentives to identify the most generous location for each industry and split up its operations into separate entities to benefit from the different rules. Under unitary combination this would however only be possible if firms formally split.

Hence, if the rules for determining taxable profits differ to the extent that substantially different profit levels are obtained depending on the set of rules used, HST could lead to inefficiencies and CBT would be preferable. Agreeing the rules for a common base could be difficult in that situation though. If on the other hand different rules produce similar overall taxable profits over time, then HST may be feasible while CBT could still be difficult to agree upon, given the need to iron out the differences of detail that exist between systems. This would then be the key case in which HST would be preferable to CBT. On the other hand, if tax rules are similar, not only in their overall results but also in their details, both HST and CBT could be feasible. As it is, the current situation in the EU is not characterised by nearly identical rules and the overall outcome in terms of taxable profits may also differ substantially.⁸²

The choice of a suitable tax rate

Under both CBT and HST each country could still set its own tax rate, which in the case of HST is assumed to correspond to that faced by companies that continue to use separate accounting. Under CBT it may be useful to allow jurisdictions to charge a different tax rate to companies choosing the reformed system, if the tax base defined according to the common rules differs from the one obtained otherwise. This would allow jurisdictions to maintain tax revenues at the same level. Under HST, however, it seems inevitable that the tax rate be the same whatever definition is used, because otherwise there would be too much scope for discrimination and international dispute.

headquarters, while others cut tax rates to attract production facilities. The total effect could be a loss in tax revenues. The introduction of some incentives would, however, be constrained by the EC State Aid rules and the Code of Conduct group on harmful tax competition, as well as any limitations imposed in setting up the HST system.

⁸¹ This is not to say that competition for the location of firms' headquarters is generally undesirable. Competition over the legal system, the efficiency of the bureaucracy etc. may well be desirable. Inefficient is competition in which a country manipulates the rules so that its own tax revenues are unaffected, but those of other countries decrease.

⁸² This can be seen by comparing statutory tax rates and effective average tax rates, i.e. tax rates that include the effects of allowances and tax rules. In 1999, the statutory tax rates in the three largest EU economies were 40% in France, 51.6 % in Germany and 30% in the UK. Effective average tax rates for these three countries differ significantly less though. For equity financed investment in plant and machinery they are in the narrow range of 16.8% in the UK to 19.7% in Germany. For investments financed by a weighted average of retained earnings, equity and debt, effective rates range from 23.5% in the UK to 31.9% in Germany (Source and exact definitions: Bond and Chennells, 2000). The difference in tax rates is thus partially compensated by differences in other tax rules. The fact that the distribution of effective average tax rates differs depending on the assumptions about the investment and its finance also suggests, that tax outcomes may be more similar for some types of firms than for others.

Companies, therefore, would face different tax liabilities depending on their country of origin. Firms based in jurisdictions where the definition of the tax base is comparatively narrow would then have a stronger incentive to take up HST than companies based in countries employing a broader definition.⁸³

So as not to cause confusion about the aims of the reform, it is advisable to attempt to keep the reform revenue neutral. A reform linked to tax increases could be unpopular with businesses despite its other advantages, while a reform linked to tax cuts might be unacceptable to governments or create the impression that the reform was caused by pressure of multinationals. Under HST this would not be possible, but under CBT revenue neutrality can, at least in theory be achieved by choosing an appropriate tax rate. In practice, however, it may be difficult to calculate a tax rate that would lead to the same level of taxation as before the reform, especially if it is unknown how many and which companies will take up CBT. Companies probably take the effective level of taxes into account; the general public, however, will be mainly interested in the level of the statutory tax rate. If for any reason the same tax rate will be charged irrespective of which base is used, then this will lead to a higher or lower level of taxes for firms opting for CBT. Obviously, if taxes are higher under CBT, very few firms would choose to take it up.

Once the system is established, quite complicated incentive effects can occur if countries can adjust the tax rate on corporate profits simultaneously with other taxes. Some countries might depend more on tax revenues from labour taxation than others and therefore charge a low corporate tax rate. Such a country would be an attractive one to locate production in. If capital is mobile and labour immobile, then such a country may face incentives to cut corporation taxes even further. While this will lead to lower corporation tax revenues (assuming that the revenue elasticity of corporate taxes is less than one), an influx of capital will lead to higher wages or less unemployment. This in turn will increase revenues from labour taxes. If labour is not completely immobile, then this will not necessarily hold, as the incidence of labour taxes will not be purely on labour anymore.

Capital export neutrality (CEN)

Under the current system CEN does not hold, either within the EU or between the EU and third countries. The reason for that is that no European country employs a perfect residence based system of taxation. As countries would still be allowed to set their own tax rates under both HST and CBT, CEN would not be achieved by the reform either. Whether the tax system would approach CEN or diverge from it depends on the assumptions made.

First it is assumed that the formula used to apportion profits is chosen so as to correctly reflect profits in each region, or equivalently that profitability is the same in each region. Under HST each company calculates its taxable profits under its home country's definition. If it invests abroad, it will face the foreign country's tax rate on part of its profits. If those countries that charge high tax rates use narrow definitions of the tax

⁸³ Or, as previously noted, companies based in those countries with a broader definition of the tax base would have to seek to change their home state to one that adopts a narrower definition of the tax base.

base and vice versa, then HST will lead to a less neutral system,⁸⁴ because a firm investing in a high tax country will no longer have the benefit of the narrow base. From the point of view of the firm, levels of tax in the EU will have become more diverse. If on the other hand countries are either generous on both accounts, i.e. have both narrow tax bases and low tax rates, or strict on both accounts, then HST will improve CEN. For a given firm EU tax levels will appear to have become more similar. In practice, there are examples of both possibilities within the EU. The effect of HST on CEN thus remains ambiguous.

Under CBT, if countries choose the tax rate in a revenue neutral way, CEN will not change on average. The differences in tax levels between countries will just become more easily observable, as they will be completely reflected in the differences in tax rates charged.⁸⁵

Dropping the assumption of perfect apportionment of profits changes the results dramatically. In that case it becomes difficult to model accurately the effect of an investment in another EU country. An example easily illustrates the case. Let us assume that a firm's foreign investment makes exactly zero profits (i.e. negative economic rents). As long as capital is one of the factors used to apportion profits, some of the profit will be apportioned to the country into which the firm is exporting capital. If the tax rate is lower in that country, tax payments will fall as a consequence of the investment; if it is higher, tax payments will increase. In such a case CEN is so much distorted that investments in low tax countries can even be worthwhile if they do not lead to profits. On the other hand investments in high tax countries may be discouraged if there is uncertainty or if profits are expected only after some initial period.

It is not just the extreme case of zero profits that this affects. More generally, whenever the expected profits (or losses) of an investment are smaller than the changes in tax liabilities, capital export decisions can be severely distorted. These arguments hold in the case of both CBT and HST. For an equivalent thing to happen under separate accounting, a firm would have to invest in a country charging a tax rate of above 100% or paying out tax credits. This does not imply, however, that separate accounting is closer to CEN. As losses of a foreign operation cannot be consolidated under SA, capital exports are even discouraged between countries levying tax at the same rate.

The conclusion of this discussion of CEN, therefore, is that the results are theoretically ambiguous. This issue can only be resolved empirically, although probably only with great difficulty.

Capital import neutrality (CIN)

While CEN can never be achieved as long as countries tax companies at different rates, CIN is achievable even without complete co-ordination. It already holds for capital

⁸⁴ As its proponents accept, see Lodin and Gammie (2001) paragraph 6.8.

⁸⁵ The distribution of tax rates could become more equal or unequal. The former will occur if countries generally charge similar amounts of taxes, but using different methods. The latter will occur if countries are on the whole either more or less generous.

imports originating from countries that apply source-based taxation.⁸⁶

On the same basis as the discussion of CEN, it will first be assumed that capital imports do not lead to changes in tax liability that are in excess of any profits or losses. In that case CBT will lead to CIN (assuming, as mentioned above, that even countries using a residence-based system will not tax profits in other EU countries). This would be an improvement for capital imports from countries that use a residence-based system. Under HST, however, CIN will not hold. Even though all firms investing in one country face the same tax rate, because their tax bases differ, their tax liabilities will differ as well.

Dropping the assumption from the previous paragraph again changes the simple results. CBT then no longer guarantees CIN. A country can thus attract zero-profit investments from countries that charge higher tax rates, while it will discourage such investments from countries charging lower tax rates. The same argument applies to HST.

Again there is ambiguity instead of clear conclusion. As long as one is willing to make the assumption that investments affect profits more strongly than tax revenue, we can conclude that CBT is preferable to HST and to SA in terms of CIN.

3.3 The territorial scope of formula apportionment

Two questions arise about the territorial scope of the reform: first, which countries will participate in the mutual recognition of their definitions of profits or agree on a common definition. Second, what is the area in which consolidation of profits is allowed.

As regards participation in the proposals, it is implicitly assumed that the whole EU would agree on the introduction of HST or CBT. As in the case of the Euro, however, it may be necessary to start with a smaller group, if not all countries wish to participate immediately, while others do not want to be held back. As in the case of the Euro, countries may be required to fulfil certain preconditions before being allowed to take part. For example, as currency fluctuations are a problem because they can strongly affect the factors used in a formula, EMU membership may be a sensible precondition for participation in the formula apportionment system.

It is possible, therefore, that only the eurozone countries would first agree to adopt formula apportionment. The initial group should not be too small though, first because it may be politically undesirable if the EU splits up in too many groups of countries converging at different speeds and second, because countries will find it more difficult to join later if they have not participated in negotiating the formula. Concerning the economic effects, the larger the initial group the better because otherwise there will be too many jurisdictions left in which companies will continue to be obliged to use separate accounting.

So far the implicit assumption was made that formula apportionment would only be used to cover those countries that have agreed on its use. It is possible, however, to apply the system to consolidated world-wide profits, even if only a handful of European

⁸⁶ Although no country in the EU uses a system that perfectly corresponds to source-based taxation, most deviations from that ideal type concern tax haven and are thus of a lesser importance for intra-EU investments.

countries have agreed on a formula and on whether to use CBT or HST. A European firm would then need to calculate world-wide consolidated profits and determine its tax liabilities to participating European governments using the formula. Tax liabilities to third countries would continue to be determined according to the rules of those countries, i.e. using separate accounting. International companies operating in Europe would need to choose one of the European states as their home state and then go through the same process as European companies.

A major disadvantage of such a solution would be that companies can be under- or overtaxed, if profits are split differently depending on whether formula apportionment or separate accounting is used. A firm, for example, that makes most of its profits in the USA but has higher sales in the EU, would have attributed much of its profits to the EU by the European authorities (if sales is one of the factors in the formula), while the US authorities would attribute most of the profits to the USA using separate accounting. This would lead to double-taxation of some of the profits of such a firm. It is equally easy to think of firms where the opposite would happen.

There have already been empirical attempts to estimate the total effect such a step would have for the US. Shackelford and Slemrod (1998) for instance estimate the US tax liabilities of multinationals would increase by about 38% if the US adopted world-wide unitary combination and a three-factor formula. Much of this increase is due to oil and gas firms. They explain these results by either higher profitability abroad, tax motivated income shifting or measurement error. They also summarise previous findings in the literature. Although the results differ, all share the common feature of estimating higher US tax liabilities than under separate accounting.

There appear to be no equivalent studies estimating the revenue effects for the EU, but given that the EU is also a net oil-importer, the results could be similar. However, even if the aggregate effects are close to zero, the distortions for individual companies affected by double- or under-taxation can be enormous. It seems advisable, therefore, to restrict the use of unitary combination and formula apportionment to the EU and to continue to use separate accounting to divide income between the EU and third countries. In the literature this is often referred to as restricting the use of formula apportionment to the 'water's edge'. In the case of the EU this term seems less intuitive and has therefore generally been avoided in this report.

It is sometimes argued that the adoption of formula apportionment will increase complexities for companies operating both within and outside of the EU, as they will have to use two systems: formula apportionment and separate accounting. In fact, the use of formula apportionment within the EU would not add any administrative difficulties to transactions with third countries, it would just fail to do away with transfer prices in that case. The total amount of transfer prices a multinational would have to determine would still decrease as a result of such a reform. This can also be compared with the current situation of US multinationals that use FA within the US, but SA for non-US operations. It would be difficult to argue that FA in the US is not efficient simply because it cannot be used on a world-wide basis.

4. The choice of formula

Provided European countries can agree on any of the definitions of the tax base discussed above, the equally important issue of the choice of an appropriate formula needs to be tackled. This choice is extremely important as it will simultaneously affect each country's tax revenue and incentives faced by companies. In the case of EUCIT, it is tax revenues rather than profits that are apportioned. With tax revenues it is possible to construct a formula based on macro-economic factors, such as GDP. On the other hand, under HST and CBT it is micro-economic factors, such as a firm's inputs and outputs, that are likely to be used to apportion profits. Unlike macro-economic factors, micro-economic factors can be directly influenced by a firm. This chapter will discuss the incentives faced by firms and jurisdictions arising from the use of such micro-economic factors.

Prior to determining a formula the issue of which countries are entitled to receive tax revenues should be resolved. Clearly countries in which none of the components of the formula are based would not be entitled to any revenue. In the USA and Canada the conditions are however more restrictive. In Canada, only Provinces in which a company has a permanent establishment are entitled to tax revenue. In the US the definition is less clear-cut, but similar in effect: A company is said to have 'nexus' with states in which it operates unless the business undertaken is only minimal business related to sales. States in which a company has sales, but no establishment would thus not be entitled to a share of tax revenues, even if sales formed part of the agreed formula. This seems a reasonable condition, especially as the location of sales is sometimes difficult to determine, e.g. if sales occur over the internet. Both the US and Canada have special provisions to deal with industries where these definitions would be difficult to apply, e.g. the transport industry. An advantage of adopting the Canadian approach is that rules to determine whether a company has a permanent establishment are already in place (but would have to include subsidiaries if unitary combination were allowed).

A starting point of the analysis of formula apportionment can be those economies that have already gained experience in using formulae. Among others, these include the USA and Canada. The most common components used in apportionment formulae are sales, labour and capital. In Canada all Provinces use a formula giving equal weight to sales and payroll. In the USA an equal weighted formula of all three factors used to be the norm, but now most States give higher weights to the sales factor. This has led to the suspicion that if there is competition for mobile capital, there will always be an incentive to increase the weight of the sales factor. Anand and Sansing (2000) however show that this is not true if some factors are immobile. In their model countries importing natural resources do face such incentives (though through a slightly different mechanism), but exporters of natural resources face the opposite incentive, i.e. to increase the weight on production-linked factors.

Anand and Sansing also show, that social welfare is maximised when states co-ordinate their choice of apportionment formula. One of the advantages of using a common apportionment formula is that over or under-taxation of businesses is avoided.⁸⁷ Once

⁸⁷ Even though different formulae can lead to over-taxation, the same tax revenue can usually be achieved (at least at the aggregate level) by using a common formula and adjusting the tax rate. In this sense the real disadvantage is not overtaxation, but lack of transparency (as differences in tax rates would be more

co-ordination has taken place, however, each state faces an incentive to deviate from the strategy. The authors therefore conclude that a system of formula apportionment in the international context is bound to be fragile. In the context of the European Union this argument may be rather weak, however, as once a treaty is made individual countries would not be able to deviate from it even if there are such incentives. This is especially true as long as fiscal reforms need to be approved unanimously. In that case, however, it may be difficult to agree on a formula in the first place.

On the premise that the aim of formula apportionment is to allocate profits to the jurisdictions where they occur, what factors should be used? There is certainly no reason to restrict the discussion to factors that are being used in other countries. The most accurate possibility would be to use profits. This would give exactly the same result as SA and would also cause the same problems. An alternative would be to use value added. The definition of value added at the firm level is output less intermediate goods and raw materials. It therefore consists of profits, interest payments and wages and salaries. The main disadvantage of using value added is that its calculation requires knowledge of the prices of intermediate goods. In case of multinational companies they will often come from abroad, and therefore transfer prices will again have to be calculated. Manipulation of transfer prices will however be less attractive to firms (and less harmful to governments), as value added comprises apart from profits also interest payments and wages and salaries. The percentage of value added that can be shifted by using manipulated transfer prices is thus considerably smaller than the percentage of profits that could be shifted.

Factors based on inputs

Another possibility is to use inputs, such as capital and labour. Profits are generally thought of as returns to capital. Therefore using capital seems an obvious candidate to be used as a factor to allocate profits. There are, however, a number of reasons why no formula is based on this single factor. First, capital is more difficult to measure accurately than payroll or sales. Most firms use historical cost accounting, usually without re-valuing assets either to compensate for inflation or to reflect changes in replacement costs. Furthermore, depreciation charges are usually arbitrary rather than reflecting true economic depreciation. In an environment of inflation, recently acquired assets would thus have higher weight than older ones. If revaluation is possible, there is an incentive to re-value assets in low tax countries, but not in high tax countries if asset prices are rising. The opposite holds if asset prices are falling.

Another problem of using capital is that some industries, e.g. the service industries, mainly use intangible capital whose valuation could well prove more problematic than the estimation of transfer prices. To deal with these issues, other inputs such as labour can be used. The determination of the payroll factor is comparatively easy, although some questions need to be resolved, e.g. whether to include social security contributions.

easily observable). At the industry level, different formulae can certainly lead to over- and under-taxation of certain industries and can therefore be used to provide incentives to certain industries at the expense of others.

The effect of using payroll as well as capital, is that no longer the location of profits is approximated, but instead the location of value added. The use of a second factor in the formula also creates the problem of having to weight the two factors. These weights should approximately reflect the percentage of value added due to capital and labour. In practice this may be difficult to determine. Furthermore the capital-labour ratios vary widely across industries (see below).

Outputs as a factor

Apart from inputs, most countries also use outputs as a factor to apportion profits. In fact, the sales factor is often the factor with the highest weighting. If the aim of formula apportionment is to replicate the distribution of profits under SA, without the need to calculate transfer prices, then the justification for using this factor is rather weak. Under SA, a jurisdiction in which only sales take place would receive very little tax revenues, only the tax on the profits made through distributing a product within a state (provided transfer prices are not manipulated). This should be replicated by the labour and property used in that state.

If sales are also used then the justification must therefore be a different one. One explanation would be that having established that within an integrated multinational it is impossible to exactly allocate profits to where they originate. After all this causes the described problems with transfer prices. If it is accepted that an exact allocation of profits is not possible, then it may not seem unreasonable to use a factor that is easy to measure and difficult to manipulate such as sales. Furthermore, philosophically it is impossible to say whether profits accrue according to where something is produced or where it is sold.

Other explanations for the use of a sales factor are the incentives that states face when choosing a formula. A state in which a company has high sales, but no or very little production, may want to claim part of the profits made by such firms. If aggregate sales in a state are high compared to production, then a state may not be willing to agree to the use of formula apportionment unless sales are included in the formula.

In US debates on formula apportionment it is often argued that States face a strong incentive to increase the weight on the sales factor. This makes the State more attractive for the location of businesses because the importance of taxes on inputs diminishes. The higher weight on sales, however, does not influence locational choices because firms would have to deal with this irrespective of where they produce. Goolsbee and Maydew (2000) have examined this issue empirically. They found that indeed States that attach higher weight to the sales factor have higher levels of manufacturing employment. This has negative externalities on neighbouring States. The aggregate effects of changes of apportionment formulae are however close to zero. As mentioned above, however, Anand and Sansing (2000) have shown that the incentives to increase the sales factor are not the same for all states, as it depends on whether they are importers or exporters of manufactured goods.

The usual procedure dealing with exports out of the area in which formula apportionment is used is to allocate such sales to the state/country in which the sale originates. This is often referred to as a 'throwback' rule. An alternative would be to exclude such sales completely. This seems more sensible, if it is believed that sales are a good proxy for the allocation of profits. In that case part of the profits are related to

third countries and should not affect the allocation of profits within the zone in which FA is used. If sales are just used as a practical measure, then it is less clear whether or not a throwback rule should be used.

Incentives faced by firms and jurisdictions

Tax reform is a complicated process, and trying to reform every tax at the same time would be an attempt doomed to failure. It is problematic, however, to deal with a single tax, such as corporate income tax, without taking into account its interactions with other taxes. McLure (1981) showed that using formula apportionment based on particular factors effectively creates taxes on these factors. These taxes however are not equivalent to taxes directly levied on these factors. A sales tax, for instance, is different from a tax on profits allocated using sales as a factor, because a sales tax needs to be paid irrespective of whether the operation is profitable. In that sense a corporate income tax is more neutral as it discourages less strongly investment that may lead to low profits. On the other hand, a sales tax is more neutral concerning investment that is meant to raise productivity because a formula that includes a sales factor would increase corporate profits for a given level of sales and would lead to higher corporate income taxes. A sales tax would not have such an effect.

There may be direct interactions with other taxes paid by companies. This may lead to complicated incentive effects for taxing jurisdictions. Mostly this arises if taxes are allowed to be expensed against corporate taxes. A state increasing such an expensable tax, e.g. a payroll tax, would increase its tax revenues from that tax, while the losses in corporate income tax revenues could partly be exported. It would be possible to deal with this by determining rules, either restricting the opportunity to impose further business taxes or by disallowing certain taxes to be expensable.

Tax incidence

The tax incidence of the current corporate income tax remains unresolved despite much research. Of interest for this report is not on what factors the corporate income tax falls but which country's residents would bear it. McLure (1981) argues that, 'a tax levied on the basis of separate accounting could probably not be shifted to non-resident consumers'. Would this change if formula apportionment were used? McLure concludes that this is unlikely. 'A state tax corporate income tax based on formula apportionment is likely to be borne in large part by residents of the taxing state'. His line of reasoning is that apportioned corporate income taxes are equivalent to taxes directly levied on factors. The incidence then falls on those factors that are immobile rather than those that are mobile.

Economic rents

As long as profits are proportional to the inputs used to apportion profits, the result will closely replicate the results achieved under separate accounting with arm's length prices (provided such prices are determined correctly). It is most likely, however, that the assumption of profits that are proportional to inputs is violated. After all, profitability varies greatly across countries, industries and individual firms. This is mainly due to economic rents that may, for example, accrue as a result of a patent. Under formula apportionment these rents are allocated across all jurisdictions, irrespective of whether they are due to a certain location or not. This may be a problem for certain location-specific rents. In the case of a patent this may not matter that much because it is likely

to be difficult to allocate it to a particular country unless it had been financed, developed and used in one and the same country. In the case of multinationals working in many member states, it is likely that most parts will have contributed to the total amount of rents earned by the company. Allocation of the rent according to payroll may therefore be better than alternative approximations. In the case of location specific rents, other taxes may be used to extract most of such rents where they originate (see however section on interaction between taxes).

Administrative issues

Administratively, the factors of sales and payroll should not pose too many problems. The only difficulty with the payroll factor is that it needs to be clearly defined, as a priori it is not clear whether this includes non-wage costs, such as social security (and private insurance) contributions. In the case of sales it may occasionally be difficult to determine the location. An internet transaction, for example, could be thought of as taking place at the location of the distributor, of the purchaser or of the server. It should be possible though to devise rules to deal with such situations. In order to cover unforeseen cases, there could be a rule to split sales across jurisdictions that justifiably make a claim on such sales.

Administratively, the most cumbersome of the classical three factors is the capital stock. There is no generally agreed measure for capital stock, and accountants and economists often take very different views on how capital should be measured. Common accounting practice is to use historical cost and more or less arbitrary methods of depreciation. The failure to allow for asset inflation can, however, lead to large discrepancies across firms, depending on when they purchased their assets. Other concepts, such as replacement cost, are extremely difficult to implement as most of a firm's capital stock is generally not traded in any given year.

More serious administrative complications may arise if different formulae are applied to different industries. Even if on average a standard formula using the common three factors capital, payroll and sales were found to be appropriate, this would not hold for all industries. In some industries one or more of the factors may not be very meaningful indicators of where profits originate. Even if no attempt is made allocate profits to where they originate, an inappropriate formula could still lead to problems by causing incentives to use manipulate the allocation of factors. An example would be a firm in the service sector (i.e. with little measured capital) with two equally profitable operations, one of which is established in a more valuable building. Because such a firm has very little measured capital, such a difference could strongly affect the allocation of profits. There may even be an incentive to invest in idle capital in a low tax country. If this is found to be common problem rather than just a theoretical possibility, then a balance must be found between defining accurate industry specific formulae and crude approximation based on very broad industry definitions. Nothing would be gained if resources freed from determining arm's length prices are instead used to determine which industry's formula is to be applied.

5. Other proposals

Recommendations of the Ruding Committee

The 1992 Ruding Committee report did not consider either CBT or HST as such. It did, however, recommend the harmonisation of tax bases and made a number of concrete recommendations for progress towards that end. It also recommended harmonisation of tax rates, at least within a range of 30% to 40%. In that respect the recommendations of the Ruding committee require more harmonisation than the options discussed here, as both the CBT and HST proposals envisage that the choice of the tax rate would remain the prerogative of each country.

Otherwise, the Ruding report carefully stresses the principle of subsidiarity and therefore does not recommend general alignment of tax systems but instead focuses on issues that pose problems to the functioning of the single market, e.g. double taxation of dividends. The Ruding Committee envisaged that these problems should be tackled by directives, e.g. the extension of the parent/subsidiary directive to all enterprises subject to corporate income taxes. The fact that not all or even the least controversial recommendations have been implemented suggests that the pace of reform will not be quick. On the other hand, due to monetary union that now exists between most states, some reform proposals that seemed unattractive at the time of the report may well be feasible now.

EUCIT

As this would do away with separate accounting in the EU, there would be no problem of determining or monitoring transfer prices within the EU. Furthermore any losses could be set off against profits, just as in the case of two domestic operations. If EUCIT is similar in structure to currently used tax systems it would not be neutral for investment decisions. At least for European companies, however, it would lead to both CEN (into EU countries) and CIN, i.e. it would be neutral for investment locations.

The disadvantage of a European corporate income tax would be that such a tax would restrict each country's possibilities to use tax policy to pursue its national economic aims. An example would be the case of Ireland, which would no longer be able to attract capital by offering a low tax rate. Without that possibility, it may be extremely difficult for less advanced or peripheral countries to compete with the most industrialised central countries.⁸⁸ This could be mitigated by allowing countries the use of tax credits (e.g. linked to investment), but at the price of re-introducing complexities into an otherwise simple tax system.

Whatever its attractiveness, this proposition does not seem feasible in the near future. The reasons include the difficulty to agree on a set of rules, as results of theoretically optimal tax systems are very vague. Most of the reasons are however political in nature, such as the need to decide fiscal policy unanimously. Instead of a short-term policy goal, EUCIT may be better thought of as a possible long-term solution to European corporate taxation.

⁸⁸ This point is made e.g. by Baldwin and Krugman (2001).

6. Conclusion

This part of the report has summarised the main shortcomings of using separate accounting within the ever more integrating European economies. The wide range of complications that arise from this concern both economic and administrative efficiency. A number of reform proposals have been discussed. Based on the assumption that corporate taxes will not be abolished in the near future, and that corporate profits (or an approximation thereof) will continue to form the tax base, the three main proposals are HST, CBT and EUCIT.

While EUCIT may seem the obvious solution, it is the least likely to be implemented or even seriously considered due to political and institutional factors, such as the desire by most countries to be able to determine tax rates according to their economic policy. HST and CBT would solve the problems associated with separate accounting while leaving the control over tax rates to individual countries. Whether or not they should be implemented depends on wide range of factors. HST can only be efficient if rules for the determination of taxable profits produce similar results. In that case HST provides a way forward for European tax reform without the need to agree on every detail of a set of often arbitrary rules. If tax rules lead to substantially different outcomes in terms of measuring taxable profits over time, then only CBT is an efficient option. The problem is that in the face of such diversity it would be especially difficult to agree on a common definition of the base.

The conclusion is that whatever path is chosen to reach an integrated European system of corporate income taxation, the premise is to create a uniform set of tax rules (not tax levels). This could be done by seeking to harmonise specific rules, a procedure which could eventually lead to CBT. If such harmonisation proves too difficult to implement, there is still the option to co-ordinate rules so that they produce similar results. This would allow the introduction of HST, which in turn may facilitate the later adoption of CBT. In any case neither HST nor CBT is likely to be the final outcome of the integration process. Instead, either proposal may prove to be a transitional arrangement for a European Union that is in the yet incomplete process of integration.

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Many suggestions have been launched, the most elaborate and creative one being the Home State Tax Model (HST). The others are more or less variations on a common base model discussed over and over again.

The merits of a common system would be that the problem of transfer pricing and offsetting of losses would be solved. This would be important indeed, but there are a number of other problems to be solved, mainly associated with the fact that the business tax rules need to be extremely complicated to match different needs and political aims and still more complicated because the economic reality is so complex. That makes the business tax system a risk of the rule of law, because no one could master the whole regulatory system. It is not possible to recognise a number of important legal concepts in real life. The courts cannot treat similar cases alike. Business decisions are delayed because tax considerations have to be made at great cost or even distorted because of their tax effects.

There appears to be a common belief that business taxation is indispensable. Not only to avoid economic discrimination between business income and salary income, but also because a part of the economic float would evade taxation otherwise.

That is wrong! Business income (profit) and household income (salary and dividends) are not comparable. Profit is the creation and accumulation of new resources (capital), whereas household income is the measure of an individual's contribution to the common production and base for individual consumption and abstention from consumption (taxation) in favour of common consumption and providing for individuals in need.

And the taxation of businesses is not at all necessary to prevent tax base erosion. The tax base profit, when kept within the boundaries of the company shell, can only be used for the production of services and commodities. The undistributed profit represents investment and capital growth, which can serve as the stepping stone for increasing the welfare of mankind in the future. The rise in capital value (accumulation of profits) will facilitate the future payment of salaries, which will be taxed in due time. The profit will (or should) be taxed when distributed and received by the shareholders or used for salary payments. In this way, the whole of the only enduring and genuine tax base – the result of people's labour – will be taxed anyway. The disappearance of company tax revenue will be partly compensated for by rising revenues from taxes on salary income and distributed profit. Today's overall tax burden of company profit taxes will then be carried by individuals in a direct form. It is currently paid indirectly by reduced salaries and/or prices raised to compensate the enterprises for their tax payments. No one carries the tax burden of the companies but the individuals. Taxing businesses only means pre-taxation and double taxation. In fact, the abolition of business taxation would solve the problem of double taxation of profits.

Taxation of businesses is (relatively) efficient only in primitive economic societies where it is not possible to tax private individuals. In a modern economy, individuals are susceptible to taxation. The tax base is very easy to assess and everyone can see what he receives in public services in return. It is also very easy to collect directly from the employers. The taxing of business profits, on the other hand, is very complicated,

harmful to economic development (tax on capital formation) and unnecessary for the prevention of tax base leakage. It gives very little tax revenue: only some 3-6 % of total revenue from taxes in developed countries.

Thus, in my opinion, the best solution to the problems we are discussing is the abolition of business taxation altogether or at least encourage the present tax competition towards reduced company tax rates. Anyway that ought to be the opinion of the business society. It is encouraging to hear that the US Treasury Secretary, Paul O'Neill, according to an article in *The Financial Times*, 19-20 May 2001, has said that 'he absolutely wants to eliminate corporate income tax' and finds 'one of the most important moves to be the abolition of taxation on companies'.

To give a more thorough presentation of my opinion, I refer the reader to my article published in the *Tax Planning International Review* (Vol. 26, No. 6, 1999) issued by the Bureau of National Affairs. What I say in the article still represents my opinion. What could be added is that Estonia has abolished the taxation of undistributed profits, which has proved to be very stimulating with respect to business activities. As a country held back in its economic activities during the Soviet regime, it has every reason in the world not to impede economic growth. So why punish the accumulation of capital by taxing it?

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